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# Financial inclusion, regulation and inclusive growth in Ethiopia

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Abstract

This study is intended to explore the link among financial inclusion, regulation and inclusive growth. The study found out that despite huge progress in the last ten years, financial inclusion is still very low. One of the major problems in enhancing financial inclusion is lack of physical access. Recently, the NBE has discouraged more financial institutions to join the financial sector by raising the paid-in capital for both commercial banks (566 per cent) and MFIs (900 per cent). In addition, access to the existing banks has also worsened by the recent financial regulation that led banks to operate through extremely conservative lending policy, though this policy may reduce future NPLs for banks, which is very positive.

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# Abbreviations

| | |
|---|---|
| AEMFI | Association of Ethiopian Microfinance Institution |
| CBE | Commercial Bank of Ethiopia |
| DBE | Development Bank of Ethiopia |
| FDI | Foreign Direct Investment |
| GDP | Gross Domestic Product |
| GoE | Government of Ethiopia |
| GTP | Growth and Transformation Plan |
| HIPC | Highly Indebted Poor Countries |
| IMF | International Monetary Fund |
| KKIs | Key informant Interviewees |
| LICs | Low-income Countries |
| MDR | Multi-Lateral Debt Relief |
| MFIs | Microfinance Institutions |
| MTDs | Medium Term Debt Management Strategy |
| NBE | National Bank of Ethiopia |
| NGOs | Non-Governmental Organisations |
| NPL | Non-Performing Loan |
| SACCOs | Saving and Credit Cooperatives |
| ROC | Return on Capital |
| ROA | Return on Assets |
| RUFIP | Rural Financial Intermediation Program |
| SMEs | Small and Microenterprises |
| SOEs | State Owned Enterprises |
| SSA | Sub-Saharan Africa |

| | |
|---|---|
| TBs | Treasury bills |
| USD | United States Dollar |
| WB | World Bank |

# 1 INTRODUCTION

In the wake of the global financial crisis, many developed and developing country governments are prioritizing stability at the individual financial institutions and systemic level by strengthening financial regulation. Even though the latter is important to make financial systems more robust, its contribution to inclusive growth might be insufficient, especially in poor countries.

The focus of this proposed research is low-income countries (LICs), in Sub-Saharan Africa (SSA). Ethiopia has been selected alongside Kenya, Nigeria and Ghana for the case study based on their differences (financial structures, and approaches to financial regulation) and potential to generalize findings to other LICs. Ethiopia is a small open, rapidly growing economy with shallow financial sector and low coverage of financial services. In addition, there is a lack of more sophisticated financing mechanisms such as leasing, equity funds, etc. On top of that, the financial sector is highly regulated and closed from foreign competition. Financial soundness indicators revealed that the financial sector in the country is profitable and stable.

The main objectives of the Ethiopian case study are, therefore, to identify and analyse:

- Structure and performance of the financial sector,
- Regulatory measures to support financial stability and promote inclusive growth,
- Management of capital account to support financial stability,
- Advantages and problems of different mechanisms for such regulation, given country characteristics,
- Identifying key national risks to financial stability, and
- Gaps in financial sector for funding inclusive growth.

To address these objectives this paper is organised in five major sections. Section 2 discusses the structures, size, service coverage, and performance of the financial sector relying on standard methodologies for assessing financial sector performance.

Section 3 discusses the status of financial inclusion and the regulatory mechanism that influence financial inclusion in the country. It investigates the relationship between financial sector and inclusion and how should regulation be designed to encourage/facilitate an optimally sized and composed financial sector for financial inclusion.

Section 4 deals with financial sector regulations, financial stability and inclusive growth. It approaches the issue from two basic perspectives: one is identifying the channels through which the financial sector can directly affect inclusive growth and the mechanisms through which regulation influences this process. The second perspective is investigating the channels through which the financial sector can directly affect financial stability and the mechanisms through which regulation influences this process.

Section 5 discusses the structure and level of capital flows, the desirable level of sustainable foreign debt, the linkage between long-term capital flows and development and how this is encouraged, how capital account management influences capital inflow and support financial stability and inclusive growth, and how can the capital account best be regulated to avoid future currency or banking crises.

Section 6 deals with existing and potential key country risks to financial stability and inclusive growth. Finally section 7 concludes the paper.

The paper used extensive literature survey and review of grey materials (policies, directives, regulations, etc) in order to be able to conceptualise the issue in context. The paper also used extensive secondary data to understand the trends in financial inclusion, to see the performance and stability of the financial sector. Data was also generated with the help of Key Informant Interviews (KIIs) with senior officials of the financial sector (public and private) and with officials of other major stakeholder of the financial sector.

# 2 Structures, Size and Performance of the Ethiopian Financial Sector

## 2.1 Structure of the financial sector

The Ethiopian financial sector/policies have evolved through three stylized stages: first, financial repression and fostering state-led industrial and agricultural development through preferential credit (in the socialist regime); second, market-led development through liberalization and deregulation (post 1991); and third, financial inclusion through allowing private banks and MFIs (since second half of 1990s). Proclamation No. 84/1994 that allows the Ethiopian private sector to engage in the banking and insurance businesses and proclamation no. 40/1996 in 1996 that allows the establishment of MFIs mark the beginning of a new era in Ethiopia's financial sector and opened the opportunity for an inclusive financial sector in Ethiopia.

Currently, the Ethiopian financial sector consists of 3 public banks[1] including the Development Bank of Ethiopia (DBE), 16 private banks, 14 private insurance companies, 1 public insurance company, 31 microfinance institutions and over 8200 Saving and Credit Cooperatives (SACCOs) in both rural and urban areas. The ownership structure of microfinance institution is mixed, with the big microfinance institutions partially owned by regional states, some by NGO's and some by private owners. The government-owned Commercial Bank of Ethiopia (CBE) is the dominant commercial bank and accounts for 70% of total assets of banks as of May 2013 (See IMF 2013:20). The balance, 30%, is accounted by the other 15 banks. Unlike many government-owned commercial banks, CBE is relatively well run and profitable.

The entry of the private sector in the financial sector has created better opportunities for enhanced access to financial services in the country directly through their operations and indirectly through the spillover effect on public financial institutions. As argued by Getahun (2009) the emergence of private banks with the spirit of competition and emphasis on profitability has led to major shift in the focus of public banks towards a more profit oriented approach. According to him, the Government has restructured these banks granting full operational autonomy, recapitalizing them and cleaning their balance sheets from bad debts accumulated in the previous socialist directed credit delivery system.

[1] The state-owned CBE is the dominant commercial bank and accounts for 70% of total assets of banks as of May 2013 (See IMF 2013:20). The balance, 30%, is accounted by all the 15 banks.

Despite those encouraging changes in its structure, the Ethiopian financial sector is not diversified in terms of the type of institutions delivering the service and the type of financial products being delivered. The financial service is dominated by a cash based system. Moreover, there is no stock market and the financial market comprising the interbank money and foreign exchange markets as well as the bond and TBs market is at an infant stage accommodating limited amount of transactions (see Table 1).

It is worth highlighting that the financial sector in Ethiopia is highly regulated and completely closed from foreign companies. The complete closure of the financial sector to foreign companies has limited the opportunities for competition in the financial sector. Also, there will be a missed opportunity in terms of capital injection, foreign exchange access and banking technology and skills. The GoE has been trying to justify such a closure on account of possible domination of the financial sector by foreign banks as the former is quite at its infant stage and the regulatory capacity of the central bank is quite limited.

## Table 1: Structure of the Ethiopian financial sector

| Indicators | 1998/99 | 2012/13Q1 |
|---|---|---|
| Number and Composition | | |
| ▪ Commercial Banks | 8 | 16 |
| ▪ Development Banks | 1 | 1 |
| ▪ Investment Banks | 0 | 0 |
| ▪ Insurance Companies | 9 | 14 |
| ▪ Mutual Fund companies | 0 | 0 |
| ▪ Credit Union | N.A | N.A |
| ▪ Micro Finance Institutions (MFIs) | 11 | 31 |
| ▪ Money Market | Non-existent | Exist but shallow |
| ▪ Foreign exchange market | Non-existent | Exist and relatively active |
| ▪ Securities market | | |
| ○ TBs Market | Non-existent | Exist but shallow |
| ○ Bond Market | Non-existent | Exist but shallow |
| ○ Capital Market (stock market) | Non existent | Non existent |
| **Number of Branches** | | |
| • Banks (including DBE) | 278 | 1376 |
| • Insurance | 79 | 252 |
| • MFIs | N.A | 1385 |

*Source: Own compilation from National Bank of Ethiopia (NBE), Annual reports, various issues.*

## 2.2 Size and coverage of financial services

### 2.2.1 Size of the financial sector

The Ethiopian financial sector is shallow (African Economic Outlook, 2012) and the coverage of financial services in Ethiopia is low (ADB, 2011). Recent studies estimated that less than 10% of households have access to formal credit (ibid). In addition, there is a lack of more sophisticated financing mechanisms such as leasing, equity funds, etc.

Starting from a very low base, the total asset of the banking system has registered an encouraging growth over the last 10 years. It increased from Birr 153 billion (USD 14.68 billion) in 2008/09 to Birr 400.9 billion (USD 21.9 billion) in 2012/13, an increase of 163%. Though from low base the growth is too fast and now the

NBE has put new regulations that slowdown the increase in the banking sector.[2] It should be noted that the banking system is the largest among the financial sector accounting for over 80% of the total assets of the financial sector.

Yet its size is quite limited compared to the financing need of the economy. According to Tsegabirhan (2010) the Ethiopian banking industry is underfinanced itself with a total capital of Birr 10.5 billion, which is about USD $840 million. This constrains the size of credit available to the Ethiopian economy. Given this limited capital base relative to the credit demand of the economy, the Ethiopian banking sector at its current size cannot be expected to finance major physical infrastructure like hydroelectric power generation projects.

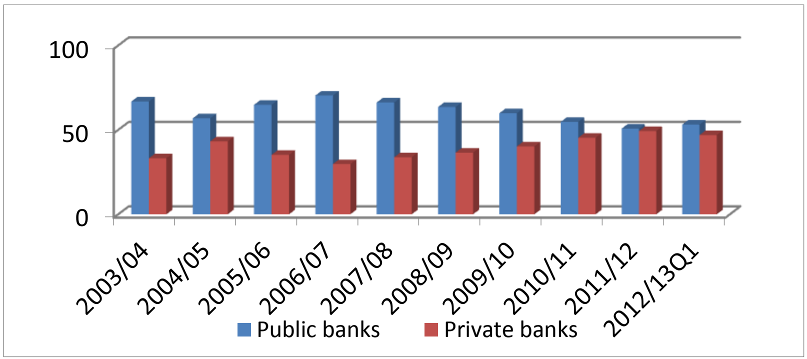
The financing need of the economy is increasing every year mainly due to the huge infrastructural projects of the Government and the expanding basic services. So, for an expanding economy registering successive double digit growth in recent years, there is a need for a diversified and highly capitalized financial sector that is capable of availing the required financing.

### 2.2.2 Total capital of the banking sector

The total capital of the banking sector excluding the central bank reached USD 1.03 billion at the end of June 2012 which was higher by 6 fold compared to 2003/04. Of the total capital, about USD 0.522 billion (50.7%) was held by the three public owned banks. The total capital of the private banks stood at USD 0.507 billion (49.3%). Commercial Bank of Ethiopia (CBE) accounted for about 34.6% of the total capital of the banking sector in the country.

It is worth to note the increasing contribution of the private banks to the total capital of the banking sector over the last couple of years. Their share in the total capital of banks increased from around 33.2% in 2003/04 to 49.3% in 2011/12. However, their share declined to 46.9% at the end of the first quarter of 2012/13 following the raise up in the capital base of the public banks (Fig. 1). Over the last 10 years, the capital of private banks has increased on the average by 28.2% on annual basis.

## Figure 1: Percentage share from total capital of banks




*Source: NBE, Annual reports, various issues*

### 2.2.3 Banking service coverage

**Branch network of banks**: The number of bank branches has increased by almost four fold over the last 12 years to stand at 1376 at the end of the first quarter of

[2] The NBE has raised the start up capital for commercial banks from 75 million birr to 500 million birr in the form of paid up capital (Directive No. SBB/50/2011).

2012/13 Ethiopian fiscal year (see Table 7 of Section 3). This is key in inclusive growth in Ethiopia.

Above all with the objective of enhancing domestic resource mobilization in the country to finance the ambitious five years Growth and Transformation Plan, public banks are being encouraged to expand their branch network. As a result, the share of public banks from the total bank branches in the country has increased at a rate faster than the private banks and still maintains more than half, 56% (see table 7 for details and branch to population ratio).

**Deposit mobilization**: Due to the observed branch expansion especially in recent years, the total deposit (saving, demand and time) mobilization of the banking sector has increased significantly from USD 4.45 billion by the end of June 2005 to USD 10.7 billion by the end of June 2012 (See Table 2). The average annual growth rate in deposit was 25.6%.

As can be observed from Table 1, the three public banks mobilized about 75% of total deposits mobilized by all commercial banks by the end of June 2005. This has shown only a modest decline within the last 8 years and accounted for 68% in 2012. The CBE alone covers 66% of the total deposit of the banking sector in 2012.

### Table 2: Deposit mobilizations by commercial banks (in million USD)

| Year | Private | Public | Total | Average exchange rate (USD/Birr) |
|---|---|---|---|---|
| 2004/05 | 1128 | 3323 | 4452 | 8.6518 |
| 2005/06 | 1502 | 3618 | 5120 | 8.681 |
| 2006/07 | 1975 | 4148 | 6123 | 8.7943 |
| 2007/08 | 2399 | 4410 | 6809 | 9.2441 |
| 2008/09 | 2864 | 4635 | 7499 | 10.4197 |
| 2009/10 | 2984 | 4667 | 7651 | 12.89 |
| 2010/11 | 3098 | 5619 | 8717 | 16.12 |
| 2011/12 | 3411 | 7290 | 10701 | 17.5 |

*Source: NBE, Annual reports, various issues*

**Loan service**: The banking sector is one of the major sources in financing the economy by providing loan to individuals, firms and the Government. Total new loans disbursed by the banking sector reached USD 3.2 billion in 2011/12, indicating nearly three fold increase to the level of loan disbursement in 2004/05 (Table 3). The average annual rate of growth of new loan disbursement by the banking sector over 2004/05 – 2011/12 period was 31.1%. The annual rate of growth of new loan disbursement over the same period by public banks was 41.1% while that of private banks was 23.8 %.

### Table 3: Loans disbursement by lenders (in million USD)

| Year | Private banks | Public banks | CBE | Total | % share of private banks |
|---|---|---|---|---|---|
| 2004/05 | 538 | 552 | 459 | 1090 | 49.4 |
| 2005/06 | 839 | 590 | 490 | 1429 | 58.7 |
| 2006/07 | 1052 | 717 | 595 | 1769 | 59.5 |
| 2007/08 | 1277 | 1671 | 1560 | 2948 | 43.3 |
| 2008/09 | 1218 | 1227 | 1065 | 2445 | 49.8 |
| 2009/10 | 1161 | 1081 | 830 | 2242 | 51.8 |
| 2010/11 | 1256 | 1362 | 1104 | 2618 | 48.0 |
| 2011/12 | 1094 | 2111 | 1825 | 3206 | 34.1 |

*Source: NBE, Annual reports, various issues*

As can be observed from the table, public banks cover 66% of the total loan disbursed in 2011/12. The CBE is the dominant bank in the country as it covered 57% of the total loan disbursed in 2011/12. Private banks all together granted USD 1.1 billion or 34% of the total fresh loans disbursed during the same fiscal year.

It is worth noting that the share of private banks in loan disbursement since 2009 is decreasing. There are several reasons for this. With the objective of controlling the recurring inflationary episodes in the country, the NBE placed severe restrictions on the lending activities of the private commercial banks since 2008. It raised the reserve requirement on commercial banks from 5% (Directive No. SBB/37/2004) to 10% effective July 2007 (Directive No. SBB/42/2007) and further to 15% effective April 2008 (Directive No. SBB/45/2008). In addition to this the liquidity requirement has also increased following the revision of reserve requirement (it is always 10% plus to the reserve requirement). This means the liquidity requirement requires banks to hold a further 25% (this is from their total reserve which includes TBs, cash including foreign exchange, etc.) in liquid reserves (only cash deposit). Following the success in getting down the inflation in the country, the NBE revised the reserve requirement downwards to 10% effective Jan 2012 (Directive No. SBB/46/2012) and further to 5% effective March 2013 (Directive No. SBB/55/2013). It should be noted, however, that the liquidity requirement remained at 20% when the reserve requirement was revised downwards to 5%. Further more, the government has come up with another directive that significantly affect the capacity of private banks. On 4 April 2011, the NBE issued a directive requiring all private commercial banks to invest 27% of their every new loan disbursements in NBE bills for five years at a very low interest rate by way of mobilising resources for strategic and priority sector investments (Directive No. MFA/NBE Bills/001/2011).

The other factor that has reduced the capacity of banks for loan disbursement was the credit cap that was set by the NBE. NBE has set the maximum net credit that can be provided by each commercial bank for each year since March 2009 up until March 2011.

All these by reinforcing each other have reduced loan disbursement activity of the private banks. Had it not been to the relatively tight monetary policy pursued by the NBE to contain inflation in Ethiopia, new loan disbursement would have been quite higher.

The share of the new loan disbursement to real sector (agriculture, industry and housing and construction) increased from 51.2% 2010/11 to 63.8% in 2011/12. This reflects the shift in loan from trade and other short-term loans towards the production sector. That is welcome, as it will lead to greater employment creation and income growth to the majority of the poor, and, thus, contribute to inclusive growth.

As it is evident from the above discussion, the monetary policy followed by the NBE has effectively lowered the relative capacity of the private banks in loan disbursement activities. This is reflected in the relative share of loan disbursed to private sector. Just like the loanable funds, the share of loan disbursement to the private sector has declined since 2009/10 (see Table 4).

## Table 4: Loan disbursement by borrowers (in millions of USD)

| | 2004/5 | 2005/6 | 2006/7 | 2007/8 | 2008/9 | 2009/10 | 2010/11 | 2011/12 |
|---|---|---|---|---|---|---|---|---|
| Public enterprises | 153.0 | 35.6 | 108.1 | 596.1 | 598.8 | 156.7 | 585.7 | 1050.0 |
| Cooperatives | 143.5 | 227.7 | 292.8 | 620.9 | 299.9 | 402.7 | 720.0 | 940.0 |
| Private | 802.9 | 1173.7 | 1397.4 | 1922.6 | 1986.4 | 2535.2 | 2743.8 | 2355.5 |
| Inter-bank | 0.0 | 0.0 | 0.0 | 0.0 | 11.9 | 32.3 | 1.3 | 6.9 |
| Total | 1099.4 | 1437.1 | 1798.4 | 3139.6 | 2897.0 | 3126.9 | 4050.8 | 4352.4 |
| % share of private sector | 73.0 | 81.7 | 77.7 | 61.2 | 68.6 | 81.1 | 67.7 | 54.1 |

*Source: NBE, Annual reports, various issues*

The outstanding loan in the banking sector (including credit to Government) reached at USD 6.65 billion by the end of 2011/12 which was higher by 100.9% over the level in 2002/03. Of the total outstanding loans, claims on central Government has declined by 71.5% and public enterprises surged by 895.3% for the same period. In the same fashion claims on cooperatives and private sector surged by 812.9 and 120% respectively for the same period. It is evident that public enterprises and cooperatives have contributed the largest share for the high growth of outstanding loan for the last ten years.

Despite the increased financing of the economy by providing loans, most of the finance (over 70%) has been going to the state and state-owned enterprises while less than 30% of the finance has been going to the private sector. That is why access to finance has been reported as being one of the critical obstacles for business development in Ethiopia in the various enterprise surveys (IMF, 2013). Unless such a financial constraint is properly addressed, the potential for inclusive finance would be limited and Ethiopia could not be able to sustain its recent growth episode.

### 2.2.4 Financing by the Development Bank of Ethiopia

The Development Bank of Ethiopia (DBE) is a specialized bank to finance medium and long-term investment projects that are in the government's priority sectors such as recently commercial agriculture, agro-processing and manufacturing. It also provides export credit guarantee services to enhance export performance and works as implementing agency for donor financed Rural Financial Intermediation

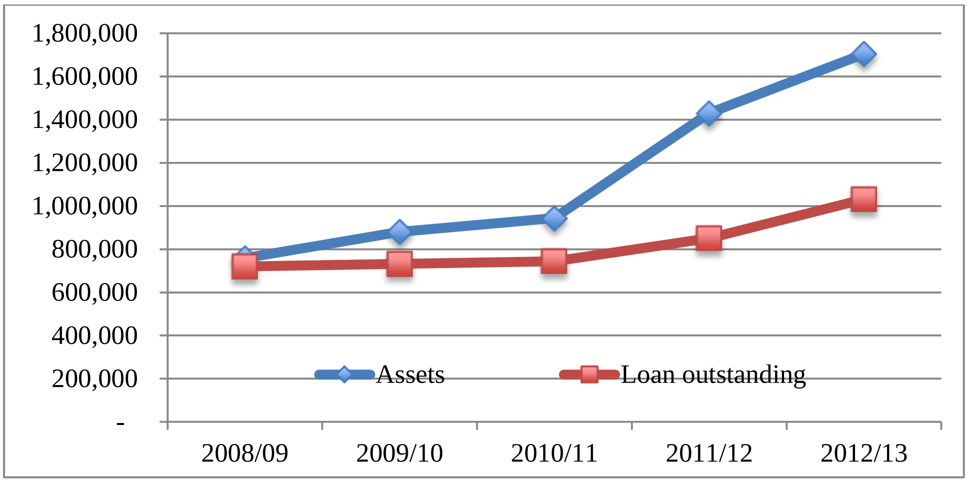
Program (RUFIP). It channels RUFIP revolving funds at low interest rate (8.5%) to Microfinance Institutions (MFIs) to lend to microfinance beneficiaries.

The DBE has different source to mobilize its loanable funds:

i) Gets loan from CBE at low interest rate;
ii) Gets soft loans from donors through Ministry of Finance and Economic Development;
iii) Generates revenue/commission by serving as implementing agency for donor financed RUFIP;
iv) Generates revenue/commission by managing funds of credit, loan provided by others;
v) Generates revenue/commission by providing guarantee to private sectors' international loans; and
vi) The 27% NBE bills that comes from private banks.3

Due to such endeavours, the total asset of the bank has almost quadrupled in a matter of five years increasing from USD 758 million in 2008/09 to USD 1.7 billion in 2012/13. Annual loan disbursement has also increased from USD 124.76 million in 2008/09 to USD 291.56 million in 2012/13. Similarly, loan outstanding has grown up from USD 719.79 million to USD 1032 million during the same period (Figure 2). Since DBE has been financing the flower as well as the textile sub-sectors, the recent employment opportunities created in these sub-sectors could be attributed to the bank contribution.

## Figure 2: Recent trends in the total asset and loan outstanding of the DBE (in millions of UDS)




*Source: DBE (2011 and 2013)*

Looking at the sectoral distribution of credit by the DBE, it can be observed that manufacturing is taking the lion's share accounting for 64.3% of the total DBE's loan by the end of June 2013. From the KIIs, it has been noticed that the single borrower limit (450 million birr-which is now about USD 23.5 million) has curtailed the bank from financing huge projects. From KII with the member of board of directors it can be understood that there is an effort to up lift this limit by

[3] On 4 April 2011, the NBE issued a directive requiring all private commercial banks to invest 27% of their every new loan disbursements in NBE bills for five years at a very low interest rate. This fund will be channelled to the DBE to finance government targeted private sector activities.

increasing the paid up capital of the bank and by bringing more resources to the bank such as pension funds.

#### 2.2.5 Coverage in MFIs services

One of the encouraging developments in the financial sector towards inclusiveness was the expansion of MFIs. Currently the country has 31 MFIs, which were only 11 in 1998/99. Of the total MFIs, 14 of them (or 46.7%) are operating in Addis Ababa. Currently, the MFIs have 1385 branches and sub-branches in the various parts of the country. They provide saving mobilization, loan provision and to some extent micro insurance services. By providing such financial services to microenterprise operators both in urban and rural areas, they opened up the start of making the financial sector more inclusive. It should be noted, however, that their contribution to these services is still extremely small.

The MFIs' capacity measured in terms of their total capital has been strengthening from year to year to reach at USD 217.1 million in 2011/12, which was a significant (568.8%) increase compared to USD 65.67 million in 2004/05. This is very small relative to the total banking system. The share MFIs' capital from the total banking system including MFIs was as small as 1.4% in 2004/05 and this has increased to 1.7% in 2011/12. Also, their total asset increased markedly to USD 760 million from USD 219.6 million during the same period (see Table 5). The share MFIs' assets from the total banking system including MFIs is also small, 4.1% in 2008/09 and this has declined to 3.6% in 2011/12.

Through mandatory and voluntary saving schemes, they mobilized deposits of USD 404.4 million by the end of 2013, which is far greater than USD 58.9 million in 2004/05. Development in loan outstanding has followed a similar rising trend as it has increased from Birr 1.48 billion to Birr 12 billion. The increase in saving mobilization and credit disbursement in the last 6 years was associated with the Government low-cost housing development programme in urban and semi-urban towns of the country. Under this programme, MFIs are providing credit for Small and Micro Enterprise (SME) operators engaged in supply of construction material for the condominium houses.

### Table 5: Performance of MFIs (in million USD)

| Particulars | 2004/05 | 2007/08 | 2008/09 | 2009/10 | 2010/11 | 2011/12 | Dec. 2013 |
|---|---|---|---|---|---|---|---|
| Total Capital | 65.7 | 145.0 | 166.7 | 184.3 | 182.8 | 214.6 | 255.4 |
| Saving | 58.9 | 168.9 | 201.4 | 206.3 | 234.5 | 311.5 | 402.4 |
| Credit | 171.1 | 484.1 | 473.7 | 451.9 | 433.7 | 530.8 | 653.4 |
| Total Assets | 219.6 | 577.7 | 635.4 | 617.4 | 630.0 | 760.5 | 930.4 |

*Source: NBE, Annual reports, various issues and EMFIA.*

The MFI sector is dominated by the four regional Governments owned large MFIs in the country, namely Amhara, Dedebit, Oromia and Omo Credit and Savings institutions. These four large MFIs accounted for 75.4% of the total capital, 88% of the savings, 82.7% of the credit and 82.7% of the total assets of MFIs at the end of 2011/12. These reflect the existence of low competition in the industry.

## 2.3 Trends in financial intermediation and financial deepening

Banks are expected to carry out financial intermediation services by allocating surplus resources from savers or depositors to borrowers. The effectiveness of banks in carrying out financial intermediation service depends on their ability to assess the benefits and costs of a given business activity, to develop suitable financial products that meet customers' requirements and to monitor loan repayment by borrowers besides the availability of their service close to customers. Existing evidence suggests that allocation of a higher proportion of finance available in an economy at any given time to the private sector contributes to economic growth (EAF, 2010).

Despite its expected role in economic development, the level of financial intermediation is quite low in Ethiopia (WB, 2013). Moreover, available evidence suggests disintermediation as there is declining trend in the key indicator - private sector credit to GDP ratio. Private sector credit to GDP ratio went down from 19.3 in 2004 to 13.9% in 2011. This is contrary to a rising trend in Sub-Saharan Africa (SSA). The SSA average has increased from 15.6 to 22.7% during the same period. A study by the WB associate such declining trend in financial intermediation to the worsening macroeconomic environment reflected by rising inflation that led to negative real deposit rate in Ethiopia (ibid).

In its latest report on Ethiopia, the IMF (2013) highlighted that over 79% of total loan issued by the banking sector in 2012/13 went to the public sector while only 21% went to the private sector. This is a rising concern on the country's ambition towards financial deepening and inclusive growth.

Looking at traditional measures of financial deepening, M2/GDP ratio went down from 40.0% in 2002/03 to 25.6% in 2011/12, which reflects a contraction in financial deepening in the country (see Table 6).

### Table 6: Trends in money supply and financial deepening (in millions USD)

| Year | CoB [4] | DD | SD | TD | NEA | Claims on CG | Claims on NCG | NOI | GDP | M2/ GDP |
|---|---|---|---|---|---|---|---|---|---|---|
| 2002/03 | 767 | 1030 | 1457 | 133 | 1288 | 2008 | 1279 | 1188 | 8474 | 40.0 |
| 2003/04 | 909 | 1181 | 1665 | 141 | 1506 | 2225 | 1384 | 1099 | 9942 | 39.2 |
| 2004/05 | 1158 | 1302 | 2001 | 186 | 1603 | 2504 | 2155 | 1096 | 12184 | 38.1 |
| 2005/06 | 1316 | 1427 | 2360 | 240 | 1395 | 2910 | 2768 | 1731 | 15014 | 35.6 |
| 2006/07 | 1559 | 1809 | 2697 | 377 | 1517 | 3450 | 3583 | 2107 | 19363 | 33.3 |
| 2007/08 | 1910 | 1914 | 3189 | 363 | 1262 | 3254 | 5073 | 2537 | 26594 | 27.7 |
| 2008/09 | 1892 | 2150 | 3565 | 312 | 1725 | 3147 | 5414 | 2368 | 31868 | 24.8 |
| 2009/10 | 1878 | 2190 | 3727 | 307 | 2109 | 2561 | 5539 | 2108 | 29413 | 27.5 |
| 2010/11 | 2021 | 2704 | 4004 | 289 | 3445 | 1777 | 6632 | 2836 | 31368 | 28.8 |
| 2011/12 | 2202 | 3218 | 4714 | 689 | 2274 | 1232 | 9573 | 2255 | 42206 | 25.6 |

*Source: Own computation and compilation from NBE, Annual report, various issues and MoFED.*

As may be observed from the table, since 2005/06 the M2/GDP ratio is always less than the ratio it has been before 2005/06. The declining trend is associated with the

[4] CoB, DD, SD, TD, NEA, CG, NCG and NOI stands for currency outside bank, demand deposit, saving deposit, time deposit, net external assets central government, non central government and net other items.

relatively tight monetary policy stance of the Government of Ethiopia over the last couple of years to combat inflation. As it is discussed elsewhere in this paper, the NBE has been using different monetary policy instruments (reserve requirement, liquidity requirement, credit cap on banks) to reduce banks' credit capacity since 2007. This has reduced the growth of broad money supply relative to GDP. While the level of GDP has increased five times, the level of broad money supply has only tripled in the last ten years.

## 2.4 Financial market performance

The financial markets of the country comprise the money market, the foreign exchange market and the capital market. While the money market is a market for the channelling of short-term funds with maturities not exceeding 12 months from a financial institution with surplus funds to another financial institution with temporary shortfalls in funding, the foreign exchange market is a market for the trading of foreign currencies against the Birr or against other foreign currencies. The capital market, on the other hand, is a market for raising long-term funds. It comprises the equity and bond markets. While the equity market help companies to raise funds by issuing stocks and shares, the bond market relates to a market to raise funds by issuing private debt securities or Government securities.

Despite its expected critical role in the country's economy, the Ethiopian financial market still remains shallow and underdeveloped. The money market, which has been in existence since 1998 has remained sluggish or latent accommodating only limited number of transaction so far. Since September 1998 a total of twenty three transactions worth Birr 259.2 million were conducted in the inter-bank money market. The interest rates ranged between 7 to 11% per year and the maturity period ranges from overnight to 5 years. It is worth noting the fact that no inter-bank money market transaction has been conducted since April 2008.

Relatively speaking, the inter-bank foreign exchange market has been active and has registered year-to-year improvement in its operations. The volume of foreign exchange traded in the inter-bank foreign exchange market reached USD 152.2 million 2011/12. This was a significant increase compared to USD 12.6 million in 2009/10. Of the total transactions in 2011/12, interbank foreign exchange trading commercial banks covered USD 90.9 million (or 60%) while the NBE supplied the remaining foreign exchange (USD 61.3 million).

The development of the TBs market that has been in existence since 1995 was not encouraging and its depth was below expectations. It could be considered as the only active primary securities market in Ethiopia although secondary market doesn't exist.

The central bank conducts the TBs auctions every week and bank and non-bank institutional investors participate in the auctions. The auction is being made for four maturity bills- 28-day, 91-day and 182-day and 364-day bills. Within the last 13 years, the total TBs offered to the market has increased from USD 1.29 billion in 1998/99 to USD 5.51 billion in 2011/12. Non-bank institutions dominate in the market by holding 88.1% of the total outstanding TBs. At the end of 2011/12, the total outstanding TBs went up by 85.4% to USD 1.14 billion. The profit from TBs is quite low and this led to lack of demand in the private sector. The average weighted profit went down from 3.56% in 1998/99 to 1.13% in 2010/11. The profit for all types of bills increased to 1.87% in 2011/12.

Long-term securities such as bonds are not widely used and traded although government bonds are occasionally issued to finance government expenditure and/or to absorb excess liquidity in the banking system. Recently, corporate bonds are expanding and the DBE introduced public bond to finance the Grand Renaissance Dam.

Data from the National Bank of Ethiopia revealed that public enterprises and regional governments have been the main issuers of corporate bonds while the CBE was the major corporate bond holder in the country. Its corporate bond holding reached at USD 3.53 billion in 2011/12 that has an increase of 41.3% compared to Birr 2.5 billion in 2010/11. Of the total corporate bond holding by the CBE, the lion’s share (79.2%) goes to Ethiopian Electric Power Corporation. This is followed by 17.8% of Regional Governments and the balance (3%) of the DBE.

# 3 Financial Inclusion

Financial inclusion is facilitating access to saving and transfer services and provision of credit and insurance at an affordable cost to unbanked poor people who have no access for formal banking system. In dealing with the financial inclusion we took two perspectives: the relationship between banking and inclusion on the one hand and how financial regulation impacts the size and composition of financial sector for financial inclusion on the other.

Financial inclusion is on progress albeit from weak base. One important aspect of this trend is the progress achieved in the coverage of bank services. One of the indicators for measuring banking access is the population per branch. Banks have increased their branches and areas of coverage from year to year and reached to 1376 branches as of first quarter of 2012/13 just from 350 in 2004/05; nearly 400% increase within 8 years. As a result, the number of people to a single bank branch has declined significantly notwithstanding that it is still high by even SSA standard (see Table 7).

### Table 7: Trends in bank branches and access

| Year | Public banks | Private banks | Regional states | Addis Ababa | Total | Population in million | Client outreach[5] |
|---|---|---|---|---|---|---|---|
| 2004/05 | - | - | 235 | 115 | 350 | 71.5 | 1:204286 |
| 2005/06 | - | - | 273 | 148 | 421 | 73.3 | 1:173634 |
| 2006/07 | - | - | 302 | 185 | 487 | 74 | 1:151951 |
| 2007/08 | 264 | 298 | 349 | 213 | 562 | 74.9 | 1:133274 |
| 2008/09 | 273 | 363 | 354 | 282 | 636 | 76.9 | 1:120912 |
| 2009/10 | 273 | 408 | 416 | 265 | 681 | 78.9 | 1:115859 |
| 2010/11 | 483 | 487 | 621 | 349 | 970 | 80.7 | 1:83196 |
| 2011/12 | 675 | 614 | 859 | 430 | 1289 | 82.7 | 1:64158 |
| 2012/13Q1 | 711 | 665 | 918 | 458 | 1376 | 84.8 | 1:61628 |

*Source: Own compilation based on NBE, Annual reports, various issues*

It should be noted, however, that significant part of branch expansion is in the capital city, Addis Ababa. Out of the total branch 33.3% is found in the capital city of the country. Within the last 8 years the increase in the number of braches is a little higher in the capital city than other parts of the country. This shows that the formal banks have still limitations in reaching out the unbanked population. Based

[5] Branch to population ratio.

on the increase in branches and technological changes access and use of financial services has been improving in Ethiopia (see Table 8).

## Table 8: Access and use of financial services

| Indicators | 2004 | 2011 |
|---|---|---|
| Commercial bank branches per 1000 $KM^2$ | 0.33 | 0.96 |
| ATMs per 1000 $KM^2$ | 0.008 | 0.16 |
| ATMs per 100,000 adults | 0.02 | 0.32 |

*Source: IMF, Financial Access Services Database*

Despite the developments mentioned above, commercial banks are characterized by several problems in relation to access to and cost of finance. IMF staff report for the 2013 (IMF 2013:20-21) stated that 'only 7.1 million have deposit accounts, i.e., less than 8% of Ethiopians have a bank account. The proportion of borrowers is even smaller (a mere 112,793)'. World Bank has also identified bottlenecks for financial inclusion in the country. In its two times surveys, WB (2009) identified that access to finance is a major constraint for formal and informal sectors in the country. Limited access to and cost of finance has been identified to have an adverse impact to enter into the sector and be productive even for the existing ones. The impact is worse on smaller and younger firms than larger and older ones.[6]

The experiences of some Asian countries (Indonesia, Bangladesh, etc) were considered as a success stories in tackling the problem of access to finance. It has been said that MFIs has reached the unbanked section of the people particularly the poor and may thus increase outreach on a sustainable basis'.

The Ethiopian government issued proclamation no. 40/1996 in 1996 that allowed the establishment of MFIs. Since then financial services to the unbanked have become a major area of interest for policy actors. The government takes financial inclusion as a policy objective and has been trying to build inclusive financial systems not only to address the previously excluded ones but also to mainstream financial institutions to reach out to the unbanked. Thus, in order to get a comprehensive picture of financial inclusion in Ethiopia, it is important to get the complete picture of the supply side such as the availability of information on non-bank financial services, such as microfinance, cooperatives, mobile financial services, and agent banking.

Currently there are 31 MFIs operating in the country. The ownership structure of MFIs is mixed- the big MFIs are partially owned by regional states and other small ones are owned by NGO's and privates. The branches of MFIs have increased as high as 1385 to meet the demands for the financial services. In terms of client outreach ratio it is one branch to 61,228 people. This reveals that still most of the population has no access to financial services.

Recently financial inclusion has become an explicit policy objective in Ethiopia as stipulated in the country's five years development plan (2010/11-2014/15), named Growth and Transformation Plan (GTP). The plan targets to create 3 million jobs, provide 15,000 hectare of land for working premises, construct shade and buildings

[6] The WB with the Ethiopian Development Research Institute has conducted productivity and investment climate survey in 2001/02 (427 firms largely manufacturing) and in 2006/07 (360 food and beverages, garment, furniture wood and metal manufacturing with more than 5 employees; 124 services enterprises; 126 informal sector enterprise defined as less than 5 employees; and 212 manufacturers repeated from 2001/02 survey - WB, 2009:10).

in the plan period (MoFED, 2010:58). Based on this, in the second year of the GTP, about 81,744 new SMEs have been created with 1.29 million jobs. The same trend has been exhibited in the third and fourth year of the plan (see Table 9).

### Table 9: Trends in performance of SMEs (loan and savings in millions USD)[7]

| | 2010/11 | 2011/12 | 2012/13 | 2013/14 (9 months) |
|---|---|---|---|---|
| No. of SMEs (cumulative) | 135,897 | 217,641 | 295,092 | 430,653 |
| No. job created | 650,00 | 1,290,000 | 2,020,000 | 1,710,000 |
| Amount of loan disbursed | 61.4 | 62.3 | 149.2 | 124.5 |
| Amount of loan collected | 55.2 | 42.3 | 96.2 | 84.4 |
| Amount saved | 19.9 | 83.4 | 186.9 | 190.0 |

Source: Federal Micro and Small Enterprises Development Agency

As may be observed from the table, the amount of loan disbursed by the MFIs, loan collected and savings of SMEs is also encouraging. The figure for repayment of loan and savings indicates that SMEs are performing as expected and used the loan productively. The microfinance industry has exhibited consistent growth in its financial services particularly in saving mobilization and provision of loan as presented in Table 10.

### Table 10: Trends in MFIs' savings and loan provision (cumulative figures in million USD)

| | Compulsory Savings | Voluntary Savings | Total Savings | Outstanding Loan | No. of active borrowers | Outstanding loan per borrower | Saving per borrower |
|---|---|---|---|---|---|---|---|
| 2003 | 14.34 | 23.43 | 37.76 | 38.46 | 746136 | 51.5 | 50.6 |
| 2004 | 17.38 | 30.24 | 47.62 | 70.68 | 622650 | 113.5 | 76.5 |
| 2005 | 25.31 | 42.19 | 67.50 | 142.17 | 939585 | 151.3 | 71.8 |
| 2006 | 38.36 | 53.68 | 92.04 | 235.57 | 1299896 | 181.2 | 70.8 |
| 2007 | 51.17 | 82.21 | 133.38 | 347.84 | 1700396 | 204.6 | 78.4 |
| 2008 | 79.51 | 81.57 | 161.08 | 507.46 | 2172823 | 233.5 | 74.1 |
| 2009 | 77.93 | 135.51 | 213.35 | 468.73 | 2197688 | 213.3 | 97.1 |
| 2010 | 63.38 | 134.91 | 198.29 | 442.67 | 2325914 | 190.3 | 85.3 |
| 2011 | 57.75 | 171.53 | 229.28 | 443.67 | 2480810 | 178.8 | 92.4 |
| 2012 | 80.40 | 232.40 | 312.80 | 548.00 | 2637625 | 207.8 | 118.6 |
| 2013 | 88.09 | 314.32 | 402.46 | 653.44 | 2821217 | 231.6 | 142.7 |

*Source: AEMFI (collected on 25 Feb 2014).*

As may be observed from the table, for the last ten years, on average, total saving has increased by 27.6%, total outstanding loan by 37.4% and total active borrowers by 15.8%. On the other side yearly savings (change in total savings) has increased

[7] The average exchange rate for 2012/13 is 18.3 (1USD/birr) and for the first nine months of 2013/14 it was 18.9505 (1USD/birr).

by 62.7% and yearly loan provision (change in outstanding loan) by 68.6%. The MFIs' total active borrowers have also increased and reached a little more than 2.8 million by Dec. 2013. This has shown an annual growth, on average, of 15.8% for the last ten years. As all borrowers are required to open deposit account (compulsory savings),[8] the same trend applies for deposit account holders. Considering the rural adult population (18yrs and above) the number of total deposit account holders (total active borrowers) in 2013 were 8,280 per 100,000 adults. In line with this Wolday (2008, as quoted by Wolday and Anteneh (2013:15) stated, "In 2011 microfinance institutions has reached only 14.5% of the households in the country". Although there has been increase overtime, the figure indicates very low level of financial inclusion. It should be noted, however, that four largest MFIs namely Amhara, Dedebit, Oromia and Omo Credit and Savings institutions accounted for 75.4% of the total capital, 88% of the savings, 82.7% of the credit and 82.7% of the total assets of MFIs at the end of 2011/12. This reflects that there exists low competition in the industry (NBE, 2011/12).

By December 2013 MFIs' total savings, total assets and outstanding loan have reached about 402.46 million birr, 930.4 million and about 653.44 million USD respectively (see table 10 and 4). Total savings covers only 61.6% of total outstanding. This is a significant deterioration when compared with what it was in 2003, 98.1%. The outstanding loan relative to total assets was also as high as 70.2%.

As can be observed from Table 4 in the preceding section, the rate at which loan increases is higher than the rate at which savings increases. MFIs are providing loans far more than what they mobilize as deposit. Although MFIs have got some funds as soft loan and donation from different sources, the stable source for loan is deposit mobilization. MFIs' capacity to provide financial services could not go hand in hand with the demand.

The average amount of loan per borrower is small though it is increasing overtime. For instance, at the end of 2013 it was as small as USD 231.6. In addition to this, there are lots of people who have no access for loan. The Executive Director of AEMFI, one of our KIIs, has noted that there is a huge demand for loan far beyond the capacity of the existing MFIs. Wolday and Anteneh (2013:15) also stated that studies also indicate that about 85% of the Ethiopian rural poor households remain without access to formal financial services. An estimated 10.4 million borrowers will require access to financial services over the next decade, which will require an investment over Birr 106 billion (which is now about USD 5.5 billion) in on-lending funds.

In the last couple of years there was no any new MFIs entry into the financial industry.[9] Given the commitment of the government for inclusive finance and growth and the current five-year development plan, this is a serious issue that demands for policy actors' attention. In order to address what is planned in the current five-year development plan, there is a need for significant increase in MFIs' outreach. The KII with different officials of the sector revealed that this is serious given the fact that formal commercial banks are not providing financial services to the poor and SMEs. Private banks are raising their capital to increase their single borrowing limit and thus scaled up their loans portfolio to the large and corporate

[8] Compulsory savings is used as collateral for the loan received and it is also believed as a promotion of saving culture. Under the five-year SME development strategy the youth who are ready to start SME are expected to save 20% of the project cost before accessing loan form MFIs (Wolday and Anteneh, 2013:16).
[9] Six MFIs are on process to get license (Interview with Mr. Frezer, Director, MFI Supervision Directorate, National Bank of Ethiopia).

entities away from the small borrowers. In addition, most private banks are focusing on large customers even for deposit mobilization.

In addition to the MFIs, low-level financial institutions such as cooperatives and credit unions are critical for financial inclusion. The country has over 8,200 SACCOs in both rural and urban areas. These cooperatives are believed to easily reach to the lowest segment of the population and also serve as a bridge between the very poor and formal banks. The problem is, however, that they cannot meet the credit needs of their members from the resource they mobilize from their members.

To recap, we have observed that the expansion of commercial banks and MFIs is very rapid, albeit from a small base. If we see this from the size of the population the country has, the financial services is still undeveloped. The overwhelming majority of the population has no access to financial services. It is observed that the supply side of financial inclusion is still poor as witnessed by very high population size per branch and very low number of deposit account holders. Given this context, NBE has still to work more in facilitating the entry for new banks and MFIs and move the existing one from traditional way of financial services to technology based services.

Considering that use of technology and innovation in financial service delivery is key to financial inclusion in Ethiopia, the NBE has approved core banking in order to make financial services more efficient and effective. It has also issued a directive (Directive No. FIS/01/2012) that governs the operation of financial service delivery through technology based financial services in order to improve the financial inclusion and to make the financial services more economical. This is an excellent development that brings the current financial service accessibility level to a better position in Ethiopia, and is considered as an important step towards inclusive financial sector in Ethiopia.

Core banking has two components intra-bank and inter-bank. The first one is networking/connecting of each branch within a given bank at the centre. This facilitates financial services for clients and reduces transaction costs for both the bank and the clients. The second one is networking of all banks at one centre. The NBE, which is responsible for this, has already selected one foreign company among many participants in the bid for implementing the core banking system. For the inter-bank network to be operational, each bank has to network all its branches. The problem, however, most banks are not even networked within themselves. Very few banks have completed branch network. Most banks activities are still traditional. This has hindered the efficiency and effectiveness of financial services and the implementation of full core banking services. Furthermore, the NBE took almost two years to reach at this stage and private banks are of the opinion that it may even take some five or more years to the full implementation of the core banking.

The other technology based financial services is channel banking. It includes internet banking, card payment system, mobile banking, and point of sales. These kinds of services are the most useful system for countries like Ethiopia where the overwhelming majority of the population has no access to financial services. All the interviewed banks are of the opinion that mobile banking will significantly reduce the overhead costs and other related transaction costs and reaches people from where they are. For clients this will bring the transaction cost (transport, time, convenience, etc.) to nearly zero and give most efficient and effective financial services. The NBE approved these services by its directive no. FIS/01/2012, effective as of January 2013 but still there is no much progress. It is worth mentioning that mobile networks are expanding in the country. Number of mobile subscribers in 2012/13 has reached 23.76 millions from 10.7 million in 2010/11 and the target for 2014/15 is 40 million. The percentage of the rural population with access (within 5 kms radius) to a telephone service has also increased from 62.14% in 2009/10 to 84% in 2012/13 and the target for 2014/15 is 100% (MoFED, 2014:53).

From the KIIs with different officials of the financial sector, two basic problems are identified for the poor progress of technology based financial services. These are the capacity of the regulatory institute and status of institutions that provide IT and energy services. Human resource in general for the financial sector is at stake. There is no financial training institute in the higher learning institutions in the country. From the interview it has been noticed that people who accumulate skills through experiences and not through formal financial/banking training are managing banks. Because of this most private banks recruited their high level employees from the public banks. Employees of the NBE are paid very low salary when compared with commercial banks. This left the NBE with young graduates who have no much experience and capacity. This has created serious capacity gap between the commercial banks and the regulatory institution, NBE. As it can be observed from the interview, in most cases it is commercial banks that generate/initiate new policy ideas. The NBE takes much time to understand and conceptualize and to issue regulation. Commercial banks are of the opinion that NBE has no full capacity to provide speedy response to commercial banks demands and is slow to adjust to new financial developments and dynamic global changes.

The other serious hindrance for the financial inclusion is the infrastructure problem. Core banking services and channel banking/technology based banking largely depends on IT and energy. In Ethiopia despite various efforts, there is serious and continuous frequent breakdown in mobile phone communication and energy. This has becoming more serious problem than ever before. Despite the government attempt to do its best to solve and create capacity, the problem still exists. One possible explanation for this might be the capacity utilization problem. The opinion is that telecommunication and energy sectors are in the government monopoly; as a result there is lack of competition in these sectors, which might be one reason for the poor capacity utilization and management in the areas. Studies also indicate that these are problem as a hindrance of promotion of financial services. For instance, Wolday and Anteneh (2013) argued that poor communication and infrastructure, limited technical capacity, weak legal system to enforce contract and low population density are the main obstacles for the development of MFIs. This implies that the existing infrastructure particularly IT and energy and limited technical capacity are the main hindrance for the financial inclusion.

On the other hand, the existing technology based banking focuses on creating convenience to account holders. It is not focused on loan services. In addition to this, people in rural areas with scatter settlement have not yet been considered from the technology side. In a country where more than 80% of the population lives in rural areas in a scattered manner and where the technology literacy rate is very low, effective use of technology remains to be questionable. Intensive public education needs to be provided on a sustainable basis.

The increase in the number of commercial banks and MFIs is most welcomed but leaves much to be desired. From our discussion with major stakeholders, it was found out that every applicant couldn't get loans and the amount they asked for.[10] Of the various reasons for this the limited supply of loanable fund (immediate

[10] Our effort to get information on total number of applicants and the capital they asked for, the amount approved and the amount disbursed was not successful.

reason is the NBE bill), the stringent procedures, single borrower limit, lack of and declining preference of private banks to small borrowers, and priority sectors are the main reasons (for detail discussion see section 4 of this paper).

From our KIIs we have found out that the existing financial system does not provide continued and adequate access for SMEs and the poor. Possible explanations for this are the following:

From the commercial banks side

i) Commercial banks do not have units for SMEs loan and are not interested to provide loan to SMEs. Because of this they do not provide continued/sustained loan access, and when they provide the amount is limited. This limited amount is even achieved through administrative arrangements rather than standard regulation. The financial system does not encourage/force private banks (other than CBE) to provide loans to SMEs;
ii) Private banks have recently raised their paid up capital in order to increase their single borrower limit and hence scaled up their loans portfolio to the large and corporate entities away from the small borrowers;
iii) The new regulations that has raised the start up capital for new commercial banks discouraged new banks to join the industry;[11]

From MFIs side

iv) Although the efforts and successes of MFIs are encouraging, according to the KIIs, MFIs are not also in a position to ensure continued financial access to SMEs and the poorer segments of society. Our understanding from our discussion with the KIIs is that MFIs do not have the financial capacity to meet the vast needs of the rural and urban poor. The overwhelming majority of rural people and urban poor have no access to financial services. The total loan provided by MFIs is supported by far lower deposit base, which severely limited access.[12] This has even raised sustainability concerns on the MFIs; and

From low-level financial institutions (cooperatives and credit unions) side

v) The presence of low-level financial institutions such as cooperatives and credit unions cannot meet the credit needs of their members from the resource they mobilize from their members' savings.

To address these issues and broaden the financial inclusion, innovative mechanisms and proper institutional arrangement are required. To begin with, the infrastructure problem needs to be given prior attention. The existing financial institutions need to exploit their existing capacity and resources through better IT service provisions. On the same line another basic issue, however, is the architecture of the financial sector. From our discussion with various stakeholders it seems that the linkage between the commercial banks and MFIs is critical where the former can dedicate a small amount of loans that can be disbursed and managed by the latter. In this

[11] Some which was close to process their application could not make it due to the high start up capital and some of these are now processing to join MFIs.

[12] MFIs also get fund from donors via the Development Bank of Ethiopia. This is a donor financed Rural Financial Intermediation Program (RUFIP). Donors channel RUFIP revolving funds at low interest rate to MFIs for on lending to microfinance beneficiaries. The Development Bank of Ethiopia manages this program. In addition to this, they also get donations from NGOs and regional governments. Government owned CBE also provides small amount for on-lending. This is how they manage their loan provision, which is far beyond their deposit mobilisation.

regard the practice of the government owned CBE needs to be encouraged. The CBE regularly provides small amount to MFIs for on-lending purpose. The NBE needs to encourage private banks to follow the practice the CBE. This linkage needs to be supported by the regulation of the NBE. Commercial banks have to work out alternative financial tools such as lease finance. A recent directive allows the establishment of lease finance under regional states as part of the MFIs but their growth would remain stunted. Making MFIs part of the commercial banks where the financial capacity is there seems worth to try.

There is also a need to link low level of financial institutions (cooperatives and unions) with the MFIs. To recap linking SACCOs with MFIs and MFIs with commercial banks seems better architecture for the financial sector for effective financial inclusion. This needs a clear direction, goal driven strategy and specific guideline at the national level. If so the financial fragmentation has to be addressed in a holistic manner.

# 4 Financial Sector Regulations, Financial Stability and Inclusive Growth

In this section we explore two relationships:

i) The relationship between the financial sector and inclusive growth and the mechanisms through which financial regulation affect this relationship; and

ii) The relationship between the financial sector and financial stability and the mechanisms through which financial regulation influences this relationship.

## 4.1 Financial sector and inclusive growth

The channel through which the financial sector affects inclusive growth and the mechanisms through which financial regulation influences this process are what have to be discussed below. The financial sector has different channels that affect growth.

1) To begin with the financial sector has to be able to build confidence in the people so as to be trusted in the services that it renders to the community. Otherwise financial transactions through the system are unthinkable. Thus the NBE that has been regulating the private banks is playing the role of making the private banks creditable. And currently the private banks are trusted by the people.

2) Secondly, physical access to financial services is critical for inclusive growth. As discussed in the preceding section, physical access though improving is still limited. One commercial banks branch is for 61,628 people as of the first quarter of 2012/13. Deposit mobilization and provision of loan is constrained by physical access. Commercial banks are concentrated in big cities and towns (33.3% in the capital city alone). For about 90 million people the country has only 16 commercial banks and one development bank. New entries to the industry is constrained by the directive issued by the NBE that requires commercial banks to raise their minimum capital from Birr 75 million to Birr 500 million, which is 566% increase, as of September 2011. Furthermore, technology based banking is not yet developed in the true sense of financial inclusion.

3) The third and most important channel is access to finance and its costs. In addition to the limited physical access discussed above, access to the existing commercial banks has been one of the major problems for inclusive growth. Different studies found out that the Ethiopian financial sector is characterised by limited access. WB (2009) based on two rounds of survey, in 2001/02 on 427 enterprises and in 2006/07 on 822 enterprises revealed that formal and informal

businesses have ranked access to finance as the second biggest constraint to their investment. To make matters worse, things are not improving and problems of access to finance became a common phenomenon. According to the 2012 Doing Business Survey, Ethiopia is ranked the 150th hardest country in the world in terms of access to credit (WB 2012). This has brought serious implications in terms of inclusive growth and employment opportunity creation and poverty reduction.

What makes access to finance a strong constraint despite its adverse impact on inclusive growth, employment creation and poverty reduction is due to the existing commercial banks preference to provide credit to large and well-established enterprises. Studies have clearly identified that banks are providing financial access to well established and large companies rather than supporting new businesses and SMEs. WB with the Ethiopian Development Research Institute has conducted productivity and investment climate survey in 2001/02 (427 firms largely manufacturing) and in 2006/07 (360 food and beverages, garment, furniture wood and metal manufacturing with more than 5 employees; 124 services enterprises; 126 informal sector enterprise defined as less than 5 employees; and 212 manufacturers repeated from 2001/02 survey).[13] From these two rounds of survey, WB (2009) concluded that all commercial banks are providing loans to larger and established enterprises and shy away from SMEs, new and young enterprises. The problem of access to credit is worse on SMEs, new and young firms. The impact of limited access to finance operates through, as the WB (2009:13) noted, ‘protecting the market share of larger businesses against competition from smaller or younger rivals’. This means financial inclusion is a serious problem for inclusive growth. The WB (2009) finds that productivity increases, investment expansion and job creation are significantly lower in firms citing access to finance as their main constraint. Studies like WB (2009) and the KIIs with major stakeholders in the financial sector support this argument.

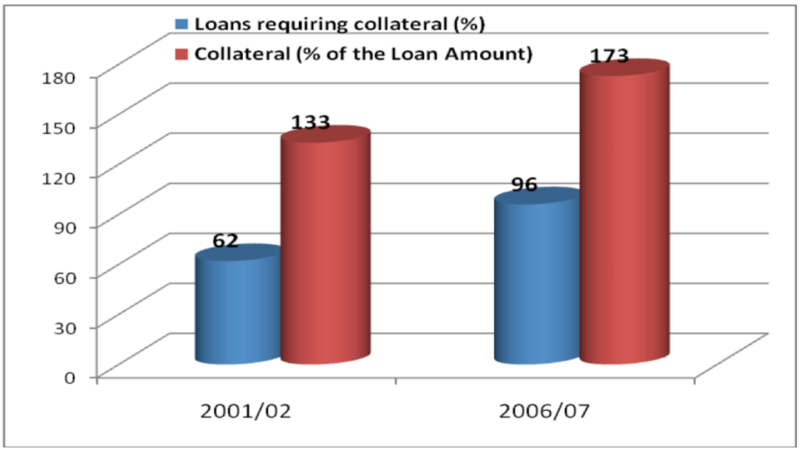
Our KIIs with officials of commercial banks and other major stakeholder in the financial sector support the WB findings. The explanation evolves around two factors: one is that commercial banks prefer large borrowers with large volume of transactions since it is easy to administer and has, therefore, lower transaction costs. This is because small and large loans need somehow the same procedures. The second factor is related to financial regulation. Commercial banks operate extremely through conservative lending policy guided by NBE directives. One of the directives is known as ‘know your customer’. This is the first and most important procedure that every applicant should qualify. For this purpose the NBE has recently established a credit history centre where commercial banks can get information about each applicant. In this process the credit history of each applicant will be scrutinized carefully including applicants’ personal life. An applicant who passes this procedure will be subjected to loan appraisal and once this is financially viable then the issue of collateral follows. Due to this very stringent process, significant number of applicant fails in the first part of the process, and among those qualifying the first stage significant number will fail again due to lack of adequate collateral. SMEs and new projects could not qualify the stringent loan process, as they have no collateral and credit history. To put in a nutshell, the credit policy of commercial banks as explained by one of the KII is ‘for the haves to have more’. Those who are new to the business and those who are in the business but do not have repeated credit history are not eligible for credit. These visible hurdles to the business are attributed to the NBE directives. It should be noted, however, that sustainable lending must find ways of discriminating between creditworthy and non-creditworthy and in most cases large and those who stay longer in the business are somehow creditworthy that the new, young and small ones. The NBE needs to

[13] See WB (2009:10).

find ways to what extent it can induce commercial banks to relax the stringent credit policy and extend their lending to new, young and small borrowers without endangering the viability of commercial banks.

The collateral requirement is also one of the major reasons that constrain access to credit with adverse impact on growth and employment creation. WB (2009) in its study found out that nearly all loans require collateral and the value of collateral is higher relative to the amount of credit requested and granted (see Figure 3).

### Figure 3: Trends in problems associated with access to finance



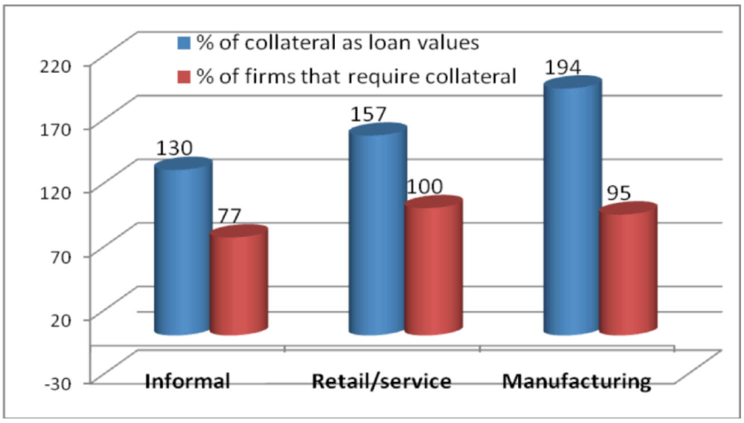

*Source: Computed from WB (2009:25)*

As may be observed from figure 3, number of loans requiring collateral and the average value of collateral required relative to loan size has increased unabatedly. In the 2006/07 survey, nearly all loans required collateral and on average each loan required collateral worth of 173% of that loan value. This is a significant increase from 62% of loans to enterprises being collateralized with 133% of the loan value in 2001/02. This figure is one of the highest rates in the developing world.[14] Ideas are not financed and the collateral requirement is still strong. Currently projects that qualify the stringent credit procedures with high financial viability will require collateral at least 125% worth of the amount of loan requested (KII with private banks).

Disaggregating collateral requirement by sectors shows an interesting story. About 95% of loans to manufacturing are collateralized with 194% of the loan value while loans to investments in retail/service sector are to be collateralized with 157% of the loan value (see Figure 4).

[14] For a detail account in comparison with developing countries see WB (2009: Figure 22).

## Figure 4: Collateral requirement by sub sector (in %)




*Source: Computed from WB (2009)*

As can be observed from the figure, the rate of collateralization is higher in the manufacturing sector than in the others. As noted by our KIIs this is largely because the loan has a long-term nature and the sector is relatively risky. This implies that the real sector that generates dynamic growth and employment opportunity are not in the interest of commercial banks. As noted by most officials of commercial banks, they provide short-term loans to trade and services but not for sectors like manufacturing whose loans often are of long-term nature.. They reiterated that their loanable fund is short-term nature and providing long-term loan is risky. The GoE needs to take such practices seriously and, in addition, respond to this financing gap by strengthening the capacity of the Development Bank of Ethiopia (DBE), whose aim is provision of long-term loans to sectors like manufacturing.

The system through which financial constraints impact inclusive growth and employment creation is mainly through limiting aggregate productivity growth and capacity utilization. Capacity utilisation, actual annual value of production relative to the yearly capacity, for large and medium scale industries has been oscillating between the range of 46% and 55% (Getnet 2010) mainly due to lack of access to finance.

Lack of access to finance has also reduced aggregate productivity through allocative efficiency.[15] Limited access to finance affects productivity at the firm level through the conduit of allocative efficiency. The effect of problems associated with access to finance on allocation efficiency manifested itself in terms of lower fixed investment and net job creation rates. The WB (2009) has estimated this impact by comparing the two investment climate surveys; 2001/02 and 2006/07. The study found, "… the average net job creation rate is lower by 44% for businesses reporting to be constrained by lack of access to external finance. This is controlling for a wide range of observable factors and unobserved and possibly idiosyncratic fixed effects. Within the same dataset, and subject to the same controls, average within-enterprise TFP is lower by about 20% for those complaining of problems of access to finance" (WB, 2009:13).

In a country like Ethiopia, financial access for SMEs is very critical for inclusive growth. Most SMEs are not in the interest of commercial banks and their demand for loan is now growing and become beyond the capacity of MFIs. Because of this SMEs are known as the 'Missing Middle'. However, SME's are generally

[15] Allocative efficiency refers to the distribution of market share across the productivity spectrum of enterprises within the industry. If more resources and higher levels of output are allocated to more productive firms in the industry, the greater aggregate productivity and, in that sense, the higher the industry's allocative efficiency or competitiveness. (WB, 2009:6).

considered as the source of employment opportunity and growth. In the case of Ethiopia, despite their expected role in employment creation and income generation, the SME sector seems to have been neglected. It appears that there is no regulation or institution or effective and comprehensive program of intervention that focuses on financing SMEs as its target. The 'missing middle' problem affect firms that are bigger in size for microfinance institutions to serve them, but too small for banks to serve their credit needs mainly due to transaction cost considerations.

Ashenafi (2013) assessed the effect of banking reform on financing SME in Ethiopia using survey data on a sample of 102 randomly selected manufacturing SMEs. His analysis suggests that the changes observed in the banking sector in the post reform period are not translated to enhance access to credit by SMEs. Among those covered in the survey only 30% of them reported as having access to a bank loan in their life time.

In the KII, all respondents highlighted the existence of financing gap for key sector such as SMEs in Ethiopia and the lack of regulation or institutional mechanism to support them. Respondents highlighted that commercial banks focus on the large and corporate sector, including the commercial sector such as import-export. The only exception is the government owned CBE, which provides loans to MFIs for on-lending purpose. But, the bank is considering the loan to the MFI to lend to SME's as a residual item after fulfilling the financing needs of the corporate sector. Thus, such financing is not of the required level.

As noted by the deputy director of Federal Micro and Small Enterprises Development Agency, cost of credit is not really an issue. What matters is the availability of funds and procedures to access what is available. With regard to the availability, Wolday (2008, as quoted by Wolday and Anteneh 2013:15) stated that an estimated 10.4 million borrowers will require access to financial services over the next decade, which will require an investment over Birr 106 billion (which is now about USD 5.5 billion). This much amounts of money cannot be mobilised by the existing MFIs given the current practice. This has to be facilitated in different ways. One is by encouraging/incentivised commercial banks to lend to SMEs. The second and may be a better solution is to link MFIs with commercial banks so that banks lend to MFIs for on-lending without endangering the banks. This calls for a directive from the regulatory institute, NBE. CBE is extending loans to the relatively large MFIs to lend to SMEs. But, such financing was not of the required level though it is on regular basis. In this regard, this practice needs to be evaluated and the government needs to draw some lessons and encourage/develop a directive so that private banks follow suit.

With regard to access to what is available, the problem is the following. As a prerequisite to apply for a loan, any SME must contribute 20% as equity in order to get the loan. In addition, an applicant should be active in related activity at least for the last six months before the application date. Our key informant stated that these prerequisites are set as a condition to make sure that the borrower is committed and use the money productively. These are some of the challenges for some SMEs who want the loan immediately and do not have the required 20% deposit. The other challenge for SMEs to access finance is the regulatory framework. MFIs will disburse new loans only if the previous loan repayment collection reached 95%. If this is not the case there will be no loan. This is acknowledged by Micro and Small Enterprises Development Agency as serious constraint to SMEs. Currently the debate is going on among major stakeholders including the Agency.

The GoE needs to consider the future of SMEs financing with a focus on the need to enhanced activities by Good Development Bank. Given the role and potential of the SME sub-sector for inclusive growth as well as for the envisaged shift from agriculture based economy towards manufacturing, Ethiopia can't afford to continue neglecting such an important sub-sector. There is a need for an effective and comprehensive program for SMEs development including its financing. In this respect, a strategy should be designed to transform the big MFI's in to micro banks, rural banks, etc so that they can increase their loanable funds through deposit mobilisation and other sources of fund. Alternatively, linking MFIs with commercial banks, as discussed in the preceding section, is also another idea worth to try.

Financial access is not only a problem of SMEs, new and young enterprises. Recently large and well-established enterprises have been also facing access problems. Recently, the GoE has been taking some measures that are likely to weaken financial intermediation via private banks and make the play field uneven for private and public banks. On 4 April 2011 (NBE Directive No. MFA/NBE Bills/001/2011), the NBE issued a directive requiring all private commercial banks to invest 27% of their every new loan disbursements in NBE bills for five years at a very low interest rate, 3%, far below from what banks pay as an interest for the deposit. The government took this action as a way of mobilising resources for government targeted private sector activities and these funds are administered by the DBE. Following the five-year development plan - GTP (2010/11-2014/15) which aims to at least lay the ground for the structural transformation of the economy from agriculture to industry, the government has fully recognised the pivotal role of the private sector in the transformation process and committed to finance the private sector in selected strategic sectors that facilitates such transformation. These strategic sectors (manufacturing and agro processing) require long-term and large loans. Private banks, however, are not interested in providing long-term loans and have also limited capacity in providing large loans (single borrower limit). It is this factor that led the GoE to issue this bill to mobilise resources and facilitate access to long-term and large loans.[16] These resources are being intermediated by the DBE, a bank established to financing long-term projects.

However, private commercial banks have serious complaint on this. These banks are of the opinion that NBE took this decision without rigorous study of the implications. The argument is that private banks' deposit mobilization is short-term nature while the 27% bill goes to long-term investment and blocked for five years. As stated above, commercial banks deposit mobilizations were short-term, and they provided short-term loans (up to 3 years) and were not in the business of providing loans for long-term investment projects. But what happened after this new directive is that more NBE bills follow provisions of short-term loans and this has exposed private banks to liquidity problems. Banks have more cash out flow than inflow. Banks faces liquidity problem to provide loans to their esteemed customers. For instance, one private bank disclosed that the approved loan amounting to 600 million Ethiopian Birr (about USD 34 million) in Feb 2012 is not yet disbursed due to lack of funds. Some private banks witnessed that their customers are now going to the government owned CBE for loans and to a lessor extent for regular financial transaction (time and saving deposit) simply because the private banks have shortage of funds.

[16] Our discussion with senior official from the Ministry of Finance and Economic Development.

As of December 2013, the NBE bill constitutes 44.3% of the total loan advanced by private banks. The amount of NBE bill is even growing much faster than the total loan advances (see Table 11).

### Table 11: Total loan by private commercial banks and NBE bills (in billion birr-cumulative)

| | June 2012 | June 2013 | December 2013 |
|---|---|---|---|
| Total loan by private banks | 40737 | 44910 | 49359 |
| NBE bills (27%) | 12577 | 18599 | 21869 |
| NBE bill share (%) | 30.9 | 41.4 | 44.3 |

The NBE bills have caused uncalled-for portfolio adjustment by banks. The adjustment taken by private banks, as the KIIs pointed out, was shifting to long-term loans so as to reduce the amount of NBE bills as the turnover of short-term loans is high. Private banks are also engaged in rescheduling loans, which is not considered as new loan and hence managed to avoid additional NBE bills. They are also engaged in fee-based projects where they only give loan guarantee for projects and simply get money for this service without even being engaged in administration. NBE was aware of private banks' reaction such as shifting to long-term loans, and came up with a new regulation that forces all private banks' short-term loans to constitute at least 40% of total loans in 2013 (Directive No. MFA/NBE Bills/002/2013). What makes matters worse is the change in the definition of short-term loans from up to 36 months maturity in the past to a maturity of only 12 months. This could lead to more funds be taken up by the NBE each time a short-term loan is advanced by banks.

The response from private banks has serious implication on investment and inclusive growth. As the KIIs from the banks noted that the banks are aware of the consequences of the 40% directive on liquidity through more NBE bills. Their adjustment was increasing the interest rate to compensate lower returns on NBE bills holding.[17] Interest rate on loan has increased up to 17 to 18% and to mobilize deposits banks have increased interest rate on time deposits up to 10% as a means of quick deposit mobilization. This has also changed the trend of the structure of deposit mobilization and also increased the cost of investment. Deposit account holders withdraw their money from saving deposit and move to time deposit. This has adverse implications, as time deposit is not stable source of resource mobilization. Shifting to long-term loans is also risky for private banks. As they explained the main problem is the source of funds. They explained that almost all deposits are short-term in nature and provision of loan to long-term investment projects based on short-term deposits is risky.

Some private banks are also trying to cope with the adverse implication of the NBE bills by aggressive deposit mobilization and expanding their branches to small towns. This is, of course, the unintended result that improves financial inclusion.

The other complaint of private banks is that there is no equal playing field. To begin with the 27% is applicable only to private banks. Secondly public sector offices and enterprises are forced to work with CBE. As a result, some private

[17] Commercial banks are free to set their lending rate. National Bank of Ethiopia only sets the minimum rate for time and saving deposit.

banks disclosed that some of their customers have already moved to CBE. In addition to limiting access to credit, the NBE 27% bill will affect bank profitability by limiting the size of loans and the losses associated with the yield rate. The bill yield only a 3% interest rate while banks pay at least 5% interest on deposits, implying at least a 2% yield loss on banks; which, through this feed back effect, further limit the size of available credit by private banks.

The other issue raised by private banks is related with recent government policy of 40/60 percent arrangement of condominium housing. In order to reduce the housing problem and support citizens to have their own house, the government issued a new program that allows citizen to buy condominium apartments by paying 40% first in five years time and the balance to be settled in long-term loan basis. Ethiopian Diasporas are expected to pay the full cost in five years to get the condominium apartments. All these resources are mobilized and administered by the public owned CBE.

In general private sector is also known for using resources more effectively and efficiently than their State Owned Enterprises (SOEs) counterparts. A recent study on China provides evidence for this. It stated, "…, between 2004 and 2008, private firms were on average 1.6 times more profitable than their SOE counterparts. … if the resources allocated to the state were given to private firms, the government would earn an extra 2 trillion Yuan in tax revenue and profit." (Han Chaohua, as quoted by EAF, 2010:2-3).[18] China, being the second largest economy, seems unsatisfied on the existing role of private sector in its economy. However, cognizant of the fact that private sector is an engine of growth; on 13 May 2010 the Chinese State Council issued a new set of guideline to promote private sector. Its 36 measures promote equal treatment of both state and private sectors.[19] Thus, the private sector is crucial in promoting inclusive growth and employment generation.

The most direct way that governments can influence the supply and the form of credit to the private sector is through state-owned financial institutions. The Government of Ethiopia is trying its best to promote poverty reduction and inclusive growth by allocating resources to private sector through its special bank, DBE. The DBE, established in 1909, is the sole bank in long-term investment financing focusing on commercial agriculture, agro processing and manufacturing sector. This is the primary real economy channel through which the banking sector facilitates inclusive growth. Private sector is the primary focus of the DBE. DBE has been assisting the private sector by providing loans to priority projects with preferential interest rate (8.5%), much lower from the market interest rate.

The major source of loanable fund for the DBE is the 27% NBE bill. This resource is being channelled to DBE to finance private sector investment projects that fall within the government priority areas. As of June 30, 2012, the total loan portfolio of the DBE on private sectors was Birr 11.8 billion (79.2%) from the total outstanding of birr 14.9 billion. As of June 30, 2013 this was Birr 14.9 billion (79.1%) from the total outstanding of Birr 18.9 billion.[20] This shows that the DBE has played a pivotal role in financing private sector investment projects.

It should be noted, however, that amount of loan disbursed to private sector has increased marginally and the proportion of loan disbursed to private sector has decreased. What seems contradictory is that this happens immediately after the

[18] We could not access the study by Han Chaohua of the Chinese Academy of Social Sciences.
[19] The measures are aimed at lowering the entry barriers for private investors in sectors such as infrastructure, municipal services, financial services, logistics and defence which have all traditionally been dominated by state titans or excluded from private sector participation altogether.
[20] Own computation from DBE (2013).

DBE has mobilised relatively huge resources through the 27% NBE bill since 2011 (see Table 12).

### Table 12: DBE's loan disbursed by sector (in million USD)

| Sectors | 2009/10 | 2010/11 | 2011/12 | 2012/13 |
|---|---|---|---|---|
| Public enterprises | - | 14.6 | 25.6 | 22.9 |
| Private | 188.1 | 202.2 | 223.6 | 215.8 |
| Cooperatives | 7.7 | 6.3 | 9.7 | 3.9 |
| Micro enterprises | 0.155 | - | - | - |
| RUFIP[21] | - | 12.2 | 4.1 | 49.0 |
| Total | 196.0 | 235.3 | 262.9 | 291.6 |

*Source: DBE (2011 and 2013).*

In 2011/12, as indicated in Table 11, the government mobilised 12.6 billion birr and in 2012/13 it also managed to earn an additional 6 billion birr by way of NBE bills from private commercial banks. The amount of loan disbursed in 2011/12 and 2012/13 to private sector is by far low (see Table 12). IMF (2013) has found an answer for this. IMF (2013:21) stated "… an analysis of DBE balance sheet reveals that more than half of the proceeds are used to buy TBs." On its implication, IMF (2013:21) further noted "This, combined with the policy of directed lending mainly to public enterprises in an environment of negative real interest rate, results in a significant transfer of resources from creditors (savers) to borrowers, especially the public sector".

IMF (2013:21) report indicated that the there is a slowdown in overall credit extension to the economy. It is reported 'Overall credit to the nongovernment sector grew by 22% over the first ten months of the fiscal year 2012/13 compared to 50% over the same period last year. Of this, 79% was allocated to the public enterprises and the rest to the private sector.

It should also be noted that the country needs to restructure the DBE to be a Good Development Bank. A Good Development Bank is one with a robust liquidity with sustainable financing resources which is capable of providing medium and long-term financing to the small, start-up and to the large investment including expansion investment particularly focusing on creating robust manufacturing base of the country and that serves as a catalyst for transforming the economy from agrarian to manufacturing.

However, currently DBE cannot be able to deliver such expected role as it highly dependent on loans from CBE and the re-routed finance from private commercial banks through the 27% NBE bill requirement. Such financing is not sustainable and there is a need for DBE to design sustainable resource mobilization strategy. Furthermore, there is a need to set-up SME financing wing within the bank to alleviate the financing constraint of the sub-sector. This will help to enhance its developmental contributions as well as profitability.

[21] The Rural Financial Intermediation Program that channels revolving funds to microfinance institutions for on lending to microfinance beneficiaries.

## 4.2 Finance, regulation and stability

The channels through which financial sector can directly affect stability are different. This requires identifying sources of instability that are linked to financial sector. Once we identify this we shall discuss how regulation influences this process.

One major source of instability is the level of financial services and credit provided. Unsustainable levels of debt may be a source of instability. The NBE directives prevent unsustainable extension of credit provided by commercial banks and MFIs by regulating these financial institutions. To this end it has been issuing different directives that limit the level of loan provided to related parties and single borrower. The directive no. SBB/53/2012 stated that maximum level of credit that commercial banks can provide should not exceed 25% of their total capital for single borrower and 15% of their total capital for a related party[22]. The NBE to regulate the level of credit provided by MFIs also issued the same directive. Directive No. MFI/18/06 which limits the level of credit states that MFIs level of credit to an individual who can provide collateral should not exceed 1% of its total capital and for an individual who can provide group collateral should not exceed 4% of its total capital.

The directive no. SBB/53/2012 also stipulated the maximum outstanding loan relative to the total capital. It is indicated, 'The aggregate sum of loans extended or permitted to be outstanding directly or indirectly to all related parties at any one time shall not exceed 35% of the total capital of the commercial bank". In addition to the NBE has established a unit that provide credit history services to commercial banks on individual applicant so as to reduce ex post risks.

The other source of instability is unsustainable/unproductive misallocation of credit to the private sector in terms of sectors. From our KIIs we understand that commercial banks have a risk mitigation strategy by limiting their loan portfolio. Commercial banks have ceilings for each sector as a proportion of total loan as a risk mitigating strategy.

The NBE has also put in place different mechanisms to reduce ex ante risks. NBE loan provision directive force banks to craft and work out Non-Performing Loan (NPL) reduction plan. This has effectively led to behavioural change in the banking system and resulted in stable, sound and profitable banking sector despite the economic challenges both at home and abroad. This is reflected in declining non-performing loan on top of rising profitability as measured in return on equity. As a result of NBE directives, commercial banks prepared and implemented NPL reduction plan over the last couple of years and this led to successive decline in NPL level which was as high as 6.8% in 2008 (Table 13) year to year to stand at 1.4% in 2012. This is an impressive performance compared to the trend in SSA, which has been between the range of 6.5 and 9.6% for the same period (WB, Finstats, 2013).

[22] Related party to a commercial bank means, on the one hand: 'a shareholder (who holds 2% or more of commercial bank's subscribed capital), a director, a chief executive officer, or a senior officer of that commercial bank and/or the spouse or relation in the first degree of consanguinity or affinity of such shareholder, director, chief executive officer, or senior officer. On the other it means a partnership, a common enterprise, a private limited company, a share company, a joint venture, a corporation, or any other business in which the shareholder, director, chief executive officer, or senior officer of the commercial banks and/or the spouse or relation in the first degree of consanguinity or affinity of such shareholder, director, chief executive officer, or senior officer has a business interest as shareholder, director, chief executive officer, senior officer, owner or partner. (NBE Directive No. SBB/53/2012).

The NBE has also issued various directives with the aim of reducing ex ante risks and promotes banks' stability. These are reserve requirements, liquidity requirements, minimum capital adequacy ratio, minimum paid up capital and the like. The reserve requirement, for instance, was raised from 5% (2004) to 10% (2007) and liquidity requirement from 15% to 20% in the same time. Every commercial bank was required to maintain 10% of all local and foreign currency deposit liabilities held in the form of demand (current) deposits, saving deposits and time deposits at all times in its account opened only for this purpose, reserve account, at the NBE effective July 2007 (Directive No. SBB/42/2007). The reserve requirement was revised upward level to 15% effective April 2008 (Directive No. SBB/45/2008) and the liquidity requirement to 25%. This means the liquidity requirement requires banks to hold a further 25% (this is from their total reserve which includes TBs, cash including foreign exchange, etc.) in liquid reserves (only cash deposit). All these monetary measures were part of the fight against inflationary pressure in the country. Following the success in getting down the inflation in the country, the NBE revised the reserve requirement downwards to 10% effective Jan 2012 (Directive No. SBB/46/2012) and liquidity requirement to 20%. As the inflation pressure is getting down the NBE further revised the reserve requirement downwards to 5% effective March 2013 (Directive No. SBB/55/2013). It should be noted, however, that the liquidity requirement remained at 20% which should have been 15%. It was always 10% plus to the reserve requirement.

In September 2011, the NBE also issued Directive No. SBB/50/2011 that sets the minimum capital adequacy ratio. As per this directive, all commercial banks shall at a minimum maintain capital to risk weighted assets ratio of 8% at all times. As of October 2013, MFIs are required to maintain at all times a minimum capital adequacy ratio of 12% computed as a ratio of total capital to total risk-weighted assets (Directive no. MFI/25/2013). The following table indicates that indicators set to protect financial stability are within the limit.

## Table 13: Indicators of financial soundness (ends June)

| | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|---|---|
| **Capital adequacy** | | | | | | |
| Regulatory capital to risk-weighted assets | 18.9 | 18.7 | 18.7 | 18.1 | 13.4 | 17.9 |
| Capital (net worth) to assets | 18.9 | 18.7 | 18.7 | 18.1 | 13.4 | - |
| NPLs to gross loans | 6.8 | 6.0 | 3.5 | 2.1 | 1.4 | 2.5 |
| NPLs net of provision to capital | 5.6 | 7.3 | 0.7 | -3.8 | -5.6 | |
| ROC | - | 31.1 | 31.3 | 36.6 | 47.2 | 48.0 |
| ROA | - | 3.2 | 3.1 | 3.2 | 3.8 | 3.2 |
| ROE (total capital)[23] | 27.7 | 31.5 | 42.2 | 31.5 | 34.2 | - |
| ROE (core capital) [24] | 29.8 | 34 | 46.4 | 34.9 | 55.8 | - |
| Gross interest income to total income[25] | 54.9 | 57.1 | 60.1 | 54.4 | 54.7 | - |
| Interest margin to gross income[26] | 46.1 | 50.6 | 38.7 | 40 | 45 | - |
| Liquidity asset to total assets | 31.5 | 30.8 | 32.7 | 32.7 | 20.6 | - |
| Liquidity assets to deposit | - | 45.5 | 42.0 | 43.0 | 28.8 | 30.1 |

*Source: NBE and IMF, 2013 (table 8)*

[23] The average capital used to calculate the ROE includes retained earnings, profits, and loss.
[24] The average capital used to calculate the ROE excludes retained earnings, profits, and loss.
[25] Total income comprises gross interest income and gross non-interest income.
[26] Gross income comprises net interest income and total non-interest income.

With the objective of enhancing commercial banks and MFIs capacity to absorb unexpected or unusual losses, the NBE promulgated a directive that sets the minimum paid up capital for new and existing commercial banks and MFIs. Since September 2011, new commercial banks shall raise birr 500 million as a minimum start up capital, which was 75 million birr in the form of paid up capital (Directive No. SBB/50/2011). Existing commercial banks are also required to raise their minimum paid up capital to Birr 500 million in less than five years time, by 30 June 2016. Since October 2013, minimum start up capital for MFIs has increased from 200,000 to 2 million birr (Directive No. MFI/25/13). This would help the financial sector to withstand difficulties, preserve it solvency and enhance its lending capacity. It is argued that banks with strong capital are in a better position to withstand shocks and enhance the confidence of depositors or borrowers (Bank Negara Malaysia, 1999).

The other bank supervision mechanism, which the NBE is trying to implement is the Basel Accord. It refers to the banking supervision recommendations on banking regulations (Basel I, Basel II and Basel III)[27] issued by the Basel Committee on Banking Supervision (BCBS). The NBE is well in Basel I. With regard to Basel II and III, there is no full-fledged implementation. As per our discussion with officials from the Bank Supervision Directorate of the NBE, it is clear that the NBE is not using Basel phase by phase, like moving from Basel I to higher level such as Basel (II and III). It is also reported that the NBE does not want to implement Basel II an III as a package. It simply takes instruments that fit in to the Ethiopian context. For instance, the NBE has drafted 'good governance directive' which is currently in circulation for comment. This directive has disclosure requirement that will force all commercial banks to avail information for the market. Each bank has to disclose its external audit. This is pillar 3 of Basel II.

It should be noted, however, that this sophisticated methods of supervision requires capacity in terms of human and financial. This may is not found in full at the NBE. The non-existence of foreign banks in the country may have also reduced the incentive by NBE authorities to adopt Basel II and III in full.

[27] They are named after the secretariat located at the Bank for International Settlements in Basel, Switzerland.

# 5 The Role of Capital Flows

The development endeavour of the country is beyond the domestic capacity both in terms of foreign exchange and capital. Both of these factors provided an apparently objective justification for foreign capital inflows. Capital inflows in the form long and short-term loans, foreign direct investment (FDI), and other flows have been financing current account deficit on the balance of payment side and in enhancing inclusive growth on the other side as some of these flows will lead to direct employment creation and income growth to the poor. In what follows, an attempt is made to throw light on the structure, level and role played by capital flows in Ethiopia; to assess recent trends and measures to attract long-term capital flows; analyse the desirable level of foreign debt in Ethiopia and measures to better manage the capital account of Ethiopia.

## 5.1 The structure, level and role of capital flows to the country

Taking account of the basic macroeconomic identity, we can locate the role of capital flows within the accumulation balance of the economy. The starting point for the macroeconomic accounting of capital flows is the identity that equates the saving-investment gap with current account and capital account. Capital flows finances the current account deficit from the capital account as follows:

Investment-saving gap = current account = capital account (1)

Algebraically this can be expressed as:

GDI-GDS=M-X = Net capital flows (2)

Capital inflows consist of public/private long and short-term loans, private capital inflows largely FDI, and other flows[28].

Based on this macroeconomic accounting framework, which ensures equality across the saving-investment account, the current account and the resulting capital account, we now attempt to place the evolution of capital inflows in the accumulation balance of Ethiopia. The accumulation balance for an economy as a whole sets out how total investment is financed. By rearranging equation 5, it follows that:

GDI = GDS + foreign capital inflows (3)

Based on this identity, one can easily locate capital flows within the actual evolution of the accumulation balance over the last decade (see Table 14).

[28] For simplicity purpose other flows includes change in international reserves, where a positive sign represents an increase in reserves, or an ‘outflow’ of capital from the capital account (this is what is left from the total net foreign capital inflow after financing of the current account deficit), net errors and omissions and depending on savings and current account definition adopted, may or may not include net factor income from abroad and net private current transfers and official transfers.

### Table 14: Saving and investment balance (ratio to GDP)

| | 01/02 | 02/03 | 03/04 | 04/05 | 05/06 | 06/07 | 07/08 | 08 /09 | 09/10 | 10/11 | 11/12 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| GDS | 6 | 4 | 12 | 6 | 5 | 9 | 5 | 6 | 5 | 13 | 17 |
| GDI | 24 | 22 | 27 | 24 | 25 | 22 | 22 | 23 | 25 | 28 | 35 |
| GDI-GDS | 18 | 18 | 15 | 18 | 21 | 13 | 17 | 17 | 20 | 15 | 18 |

*Source: NBE, Annual report, various issues*

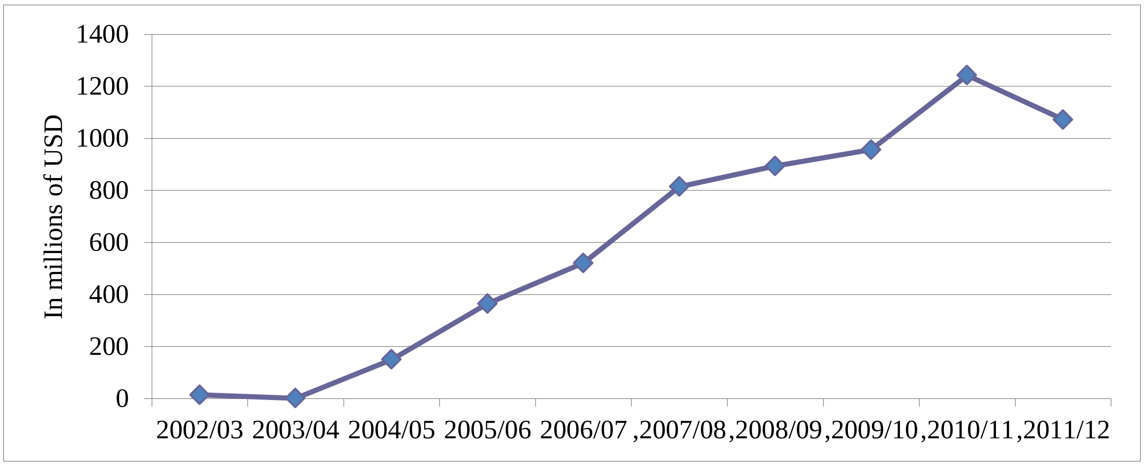
The above table heralds the macroeconomic evolution of the failure of the economy to provide an internal financial base for the investment effort and the need for the capital inflows to bridge the gap. The Ethiopian economy has been characterized by lower saving rate notwithstanding high investment rate. The gap between the saving and investment rate has always been much higher than the saving rate itself except the last two years where saving rate has achieved significant increase. Given such structural investment-saving imbalance, Ethiopia has been experiencing large current account deficit. This has been calling for capital inflows to finance the deficit as presented in Table 15. Ethiopia has been receiving significant amount of capital inflows in the form of long-term concessional loans (for government and state owned enterprises). In general compared to any other time in its history, Ethiopia has received significant amount of long-term loans that is largely concessional in recent years from multilateral and bilateral donors.

This capital inflow in the form of long-term loans has been instrumental in financing huge infrastructural projects and development of capacity building (human capital, administrative capacity, institutional building, and policy reforms). In has been financing import bills and investment and through this it has been influencing the growth of the economy positively.

The current account deficit could not be bridged by external loans from multilateral and bilateral donors alone. Private capital inflow has been almost zero in the socialist regime (1974-1999). But following the change of the government in 1991 the economy has been slowly liberalized and the GoE has also been trying its best to attract private capital inflow by revising the investment law. This has led to significant increase in private capital inflows particularly in FDI forms since 2005/06. Other forms of private capital inflow such as portfolio equity flows, bond flows and cross-boarder bank lending are insignificant. The total FDI flows has increased from USD 14 million (0.17% of GDP) in 2002/03 to USD 1.24 billion (3.96% of GDP) in 2010/11. Then it levelled at around USD 1.1 billion in 2011/12 (see Figure 5). This performance of the FDI sector is quite surprising as it is happening amidst investors' nervousness following the recent business licensing and registration requirement and the possible crowding out of the private sector with respect to access to credit.

Although there are immediate positive impacts of private capital inflows particularly FDI in terms of employment generation, technology and skill transfer; most studies have been unable to provide conclusive evidence about the positive impact of private capital flows on economic growth. In a recent survey, Massa (2013:4) stated, "… some papers show that private capital flows enhance economic growth, while others report that there is no direct evidence of such a relationship. Some papers also find that private capital inflows have a negative impact on economic growth." It should be noted, however, that the impact of FDI on growth is more or less found to be positive. As highlighted in Massa (2013:4), most empirical evidence highlight the existence of a positive and significant impact of FDI flows on economic growth in low income countries. The main channels through which FDI may affect growth are capital formation, technology transfer and spillover, human capital enhancement (i.e. augmentation of the level of knowledge in the host country through labour training and skill acquisition), and increased competition (Massa 2013)[29].

### Figure 5: Trends in FDI




*Source: NBE, Annual reports, various issues*

In short, capital flows in the form of loans, FDI, and other flows have been the main financers of the current account deficit in Ethiopia. The increased FDI flow in to the economy, particularly in the flower and textile sectors has been creating a number of job opportunities for the unemployed youth and women in the country. In this regard FDI's contribution to inclusive growth is quite immense in Ethiopia.

### Table 15: Trends in balance of payments (millions of USD - 2001/02-2011/12)

| | 01/02 | 02/03 | 03/04 | 04/05 | 05/06 | 06/07 | 07/08 | 08/09 | 09/10 | 10/11 | 11/12 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| X-M | -1243 | -1374 | -1986 | -2815 | -3592 | -3941 | -5345 | -6279 | -6426 | -5506 | -7909 |
| Net services | 105 | 36 | 247 | 242 | 148 | 230 | 160 | 386 | 457 | 688 | 75 |
| Private transfers net | 349 | 495 | 777 | 1023 | 1226 | 1729 | 2388 | 2707 | 2710 | 2747 | 3246 |
| CAD | -790 | -843 | -963 | -1550 | -2218 | -1982 | -2797 | -3186 | -3260 | -2071 | -4588 |
| Public transfers net | 435 | 600 | 571 | 750 | 756 | 1199 | 1312 | 1552 | 1906 | 186 | 1788 |
| CAD including public transfer | -356 | -243 | -393 | -801 | -1463 | -783 | -1484 | -1634 | -1354 | -1886 | -2800 |
| Capital account | 506 | 302 | 353 | 584 | 633 | 799 | 1031 | 1665 | 1996 | 2473 | 2080 |
| Public long-term | 502 | 349 | 388 | 440 | 293 | 308 | 306 | 739 | 1044 | 1387 | 1129 |
| Short-term | 5 | -61 | -36 | -6 | -25 | -31 | -90 | 32 | -4 | -157 | -121 |
| FDI | 0 | 14 | 1 | 150 | 365 | 521 | 815 | 894 | 956 | 1243 | 1072 |
| Net errors and omissions | 128 | 258 | 180 | 115 | 1024 | 102 | 193 | 525 | -363 | 681 | -280 |
| Overall balance | 279 | 317 | 141 | -101 | 194 | 117 | -261 | 555 | 279 | 1269 | -1000 |

*Source: NBE, Annual report, various issues*

[29] The literature on the channels through which FDI affects growth is vast. For a comprehensive survey of this literature we refer the interested reader to De Mello (1997) and Ozturk (2007), among others.

## 5.2 Measures to encourage long term capital flows to Ethiopia

The GoE has been taking measures to encourage long-term capital inflows to Ethiopia. The following could be mentioned in this respect.

i) Improving the operation of remittances: The NBE issued a directive on international remittance services in 2006 to improve the operations of the formal remittance service in Ethiopia, to make remittances transfers more cost-effective, and to make the international remittance service more accessible, more reliable, and faster. This directive obliged remittance service providers to reveal the terms and tariffs applicable to remittance service and to be transparent regarding the estimated time that it will take the money to reach the receiver as well as the exchange rate used to convert the foreign currency to domestic currency. Such changes coupled with the increased investment opportunities and the depreciations of the Birr are believed to have contributed to the increased remittance inflows to Ethiopia.

ii) Making the exchange rate more competitive: The GoE has a deliberate policy of gradual nominal exchange rate depreciation. It has annual nominal depreciation target of 5% and in exceptional circumstances one off devaluation is made to avoid real appreciation of the exchange rate in period of high domestic inflation to encourage key exports. Such a policy was adopted in January and July 2010 and later in September 2011.

iii) Availing 70% of the capital for FDI investment in priority areas: This is an excellent incentive for FDI flows to be attracted to Ethiopia. The recent expansion of investment in the flower and textile sectors could be partly associated to this measure.

iv) Providing land at lower tariff for commercial investors in agriculture: This led to expansion of investment in commercial agriculture in the border areas of the country by investors from India, Saudi Arabia and other countries. Ethiopia has made more than 4 million hectares (9.9 million acres) of land available for agriculture companies that meet government requirements. As of May 2011, about 285,000 hectares has been leased for commercial farming and 10 foreign investors have invested a total of USD 2.5 billion in commercial agriculture in Ethiopia. The dominant one, among them, is Saudi Star with an investment of USD 1.98 billion. But, such a measure led to a wide spread land grabbing criticism from activists and the donor community.

v) Providing land for free for the establishment of industrial zones in the country: This led to the construction of Industrial Zones in some parts of the country by Chinese and Turkish investors. The Chinese industrial zone was constructed in Eastern Ethiopia (40 km from Addis) in an area of 2000 sq. meter and another one under construction in western part of the capital. The Turkish industrial Zone is under construction north of Addis Ababa within 20 km radius.

vi) The GoE plans a debut Eurobond once it has secured a credit rating. For this purpose the GoE for the first time invited the three internationally known rating agencies (Standard and & poor's, MOODY's and Fitch) to assess its economy. These agencies have completed their six months study focusing on fiscal policy, debt profile and management, service provision and the like. The rate given to Ethiopia is B+ (B1) by MOODY and B by the other two rating agencies. The rating agencies reported that the Ethiopian debt is sustainable and the country has good working environment and institutional arrangement (as reported by the Minister for the MoFED).[30] This is a very good result for Ethiopia to attract more capital flows in different forms; bond and FDI. This might encourage the GoE to sell bonds and encourage more capital flows to the country.

## 5.3 Better ways of regulating capital flows to Ethiopia

### 5.3.1 The debate: capital account liberalization vs capital controls

Given the increasing capital flows to the country and huge saving and foreign exchange gap in the economy, the interesting question is should Ethiopia move on and try to broaden the scope of capital flows including different forms of private capital flows? In light of this, there is a need for a better understanding of the adequateness of the existing different tools available to manage capital flows.

Argument towards full capital account liberalization was dominant in the global economic sphere before the advent of the Asian financial crisis and the Latin American debt crisis. This was due to the perceived benefits it brings to economies including financing investment and stimulating economic growth, diversifying risk; improving government policy and increasing efficiency of the financial sector (Miles and Scott, 2005). But, the experience of the currency crisis that resulted in painful economic recession in countries such as Thailand, Korea, Indonesia, Brazil and Argentina have led to rethinking on such policy direction. According to Epstein et.al (2003), "following the Asian crisis of the late 1990's, there has been a renewed interest in the role of capital controls in developing countries within both policy and academic circles."

Since then there has been on-going debate on the contribution of capital account liberalization to economic growth. According to Miles and Scott (2005) capital account liberalization by itself is not a sufficient condition for economic growth, and they stressed the importance of sequencing and bundling with other appropriate policies. Critical among these is the existence of a vibrant, experienced and adequately regulated domestic banking sector.

Such debate on capital account liberalization visa vie capital control has intensified after the recent global financial and economic crisis. According to Subbarao (2013) the recent crisis has led to a significant shift in the thinking around capital account management. He categorized these shifts in to three as highlighted below: the movement away from fully open capital account, the use of capital controls as a stabilization tool and the desirability of foreign exchange interventions.

**The shift away from fully open capital account**: In the pre-crisis period, the consensus was for countries to move towards a fully free capital account with no restriction on capital from freely entering and exiting a country. But, the experience of emerging economies with capital control regimes has changed the view dramatically. These countries were successful in preventing the impact of the crisis as the control enabled them to prevent the entry of toxic financial products in to their financial system (ibid).

**The use of capital controls as a stabilization tool:** Pre-crisis consensus was against the use of capital controls as a stabilization tool. But, the crisis led to a rethinking and countries are considering capital controls as a desirable and appropriate stabilization tool in periods of economic turmoil. The current debate has shifted away from their desirability as stabilization tool to what constitute an effective capital control instrument. Capital control instruments are categorized in to two: price based and quantity based. While price-based controls use measures such as taxes to affect the level of flow of capital to and from a country, quantity

[30] Addis Zemen daily News Paper, 73rd year No. 257, May 25, 2014.

based controls relates to measures that directly limit the amount (volume) of capital flows both in and out. Price-based controls seems to be the most preferred by countries compared to quantity based since the later are gauged to be distorting and less desirable from efficiency and equity perspective.

**Foreign exchange intervention:** The third basic shift initiated by the advent of the crisis is the desirability of foreign exchange interventions. During the pre-crisis period, foreign exchange interventions were considered as inefficient instrument with suboptimal effect on capital flows. But, the crisis has forced countries even in developed ones to intervene in the foreign exchange market to defend their currencies. It is highlighted that interventions in the foreign exchange market is quite complicated if there are rising capital flows beyond the absorbing capacity of countries. According to Subbarao (2013) interventions without liquidity sterilization measure could lead to inflationary pressure and asset price bubble. On the other hand, intervention in the foreign exchange market bundled with measures to sterilize liquidity could attract more capital flows thus leading to the Dutch disease scenario. It is worth noting the reserve draw down implication of foreign exchange interventions in countries with limited foreign exchange reserves.

In short the argument towards full capital account liberalization is losing momentum and countries are adopting capital controls to withstand shocks created by global economic and financial turmoil. Currently, the intellectual debate is on how to achieve an effective capital account management.

### 5.3.2 Capital account management instruments in Ethiopia and the way forward

As highlighted in the 2012 IMF's Exchange Regulation and Arrangements, Ethiopia is exercising control on a number of capital transactions including capital market securities, money market instruments, collective investment securities, derivatives and other instruments, commercial credits, financial credits, guarantees and financial backup facilities, direct investment, liquidation of direct investment, real estate transactions, commercial banks and other credit institutions and institutional investors (IMF, 2012).

Regarding the type of instrument used, the current practice in Ethiopia is more towards quantity based capital account management instruments: prohibition, ceiling, or partial permit, etc. Derivative operations are prohibited, real estate transactions abroad are prohibited, there is a ceiling on net exposure in foreign currency, foreigners are not allowed to invest in domestic securities, equity investment by foreign firms is strictly regulated, residents are not allowed to invest abroad, financial institutions are not allowed to borrow from abroad, external loan and supplier credit are allowed to exporters and FDI firms only.

However, given the huge financing requirements of the economy, Ethiopia can't afford to restrict capital inflows in to the country by imposing strict capital control regime. The current capital account management regime should be revisited by authorities to loosen some of the restrictions. In revisiting the capital account management regimes, it might be worth considering the following design considerations and potential instruments of capital control.

Ostry et.al. (2011) underscore the need for capital control instruments to be tailored to fit country circumstances for them to be effective in achieving their intended goals. They forwarded four key design questions for consideration by countries. These are:

- Should controls be imposed only in the face of flows that are expected to be temporary?
- Should controls be broad or targeted at the risky flows?
- How can circumvention be limited?
- Should controls be administrative (quantity-based) or price-based?

From macroeconomic perspective, the suggestion is to apply capital controls only on temporary flows, and capital control instruments should be price based and broad with limited exemptions. On the other hand, from financial stability angle, the suggestion is to apply capital controls on temporary persistent flows, and capital control instruments should be quantity based and targeted taking account of circumvention (avoidance of control) possibilities. Another design consideration is the administrative ease of imposing a particular capital control instrument.

Gallagher (2011) provided an excellent summary of available techniques and practices on capital flow management. As revealed below, there are more instruments on the inflow side than on outflows.

## Table 16: Capital flow management techniques

| Inflows | Outflows |
|---|---|
| Restrictions on currency mismatches | Limits on ability of foreigners to borrow domestically |
| End use limitations | Exchange controls |
| Unremunerated reserve requirements | Taxes / restrictions on outflows |
| Taxes on inflows | Mandatory approvals for capital transactions |
| Minimum stay requirements | Prohibitions on outflows |
| Limits on domestic firms and residents from borrowing in foreign currencies | |
| Mandatory approvals for capital transactions | |
| Prohibitions on inflows | |

*Source: Gallagher, 2011.*

While acknowledging the need for a much more detailed study on the feasibility and cost benefit of introducing new instruments of capital control, based on our light touch assessment of the country context at this point in time, it is possible to suggest the following for consideration by authorities.

**A) Inflows**

**Foreign direct investment**: Ethiopia should broaden the scope for FDI by allowing some sectors to gradually open their doors to foreigners. This could be in wholesale business, transport, financial sector, telecom, real estate, etc. The modality could be through a joint venture arrangement with Government or domestic private sector firms. In the politically sensitive sectors such as financial sector and telecom, foreign firms could initially be allowed to engage on selected and technical sub-sectors such as mobile banking, internet service provision, etc.

**Portfolio investment**: Ethiopia has not benefited from equity financing thus far as there are restrictions. Given the recent rising interest towards equity investment by Shulze Global Investment and CDC, it is time for Ethiopia to reform the equity regulations that has been limiting foreign institutional investor ownership of share capital.

**External Loan and Suppliers Credit**: Currently, only exporters and FDI firms are allowed to access external loan and suppliers' credit. This is considering their foreign exchange generation capacity, which could be used to repay those loans secured from abroad. Yet, such discriminatory measures continue to be criticized by import substituting firms. They argue that since import-substituting firms are contributing to the economy by saving foreign exchange, the scheme for external loans should be expanded to accommodate firms engaged in import substitute productions.

**B) Outflows**

**Profit repatriation by FDI firms**: Given the keen interest to attract greater FDI, it would be beneficial if the current tight requirements regarding profit repatriation by non-resident firms be revisited.

**Investment abroad by domestic firms:** Restrictions on domestic firms to invest abroad should be loosened to allow some emerging firms gain global recognition and greater market access. But, such investments should be with a limit on amount to be invested and for selected sectors to which Ethiopian firms have comparative advantage. For instance, Indian firms were allowed to invest in foreign companies with a quantitative restriction that the investment amount should be less than 25% of the company's worth (Epstien et.al, 2003).

**Bank branch opening abroad**: With the objective of mobilizing more foreign exchange from abroad, the state owned CBE was allowed to open branch in South Sudan. This is the first time that an Ethiopian Bank has started operation in a foreign country. Currently, such a privilege was not granted to private banks. But, from the point of view of fairness as well as to enhance the benefits to the country it would be wise for authorities to expand the scheme to cover private banks.

## 5.4 The desirable level of foreign debt to Ethiopia

The External debt level of Ethiopia has been on a rising trend particularly following the 1992/93 structural adjustment programme of the country. Between 1992/93 and 2004/05, the debt level has increased from USD 3.7 billion to over USD 6 billion (average annual increase of 5.7%).

Thanks to the Highly Indebted Poor Countries (HIPC) and Multi-Lateral Debt Relief (MDR) initiatives for debt forgiveness, Ethiopia's external debt level was reduced to USD 2.31 billion (MoFED, 2012). The contribution of the debt forgiveness is quite evident as the external debt to GDP ratio significantly went down from 39.8% a year before the debt forgiveness (2004/05) to 11.8% of GDP in 2006/07. It constantly increased thereafter and reached USD 8.87 billion (20% of GDP) at the end of June 2012 and further to USD 10.2 billion (23.2% of GDP) in 2012/13 (see Table 17). Of the total outstanding external debt stock in 2012/13, multilateral loan account for 46.4% followed by commercial loan (33.5%) and loan from bilateral creditors (20.1%). Compared to the position in 2011/12, borrowing from bilateral and commercial creditors recorded a significant (29.2% and 23.9%) increase (Table 17).

The total debt stock (domestic and external) reached USD 13.3 billion at end June 2012. This was the result of increased disbursement from new external loans. Out of the existing public debt the external debt represented about 67% while the share of domestic debt was 33%. This shows a significant increase in the domestic debt.

### Table 17: External public debt (in millions USD)

| Particulars | 2007/08 | 2008/09 | 2010/11 | 2011/12 | 2012/13 | % change | |
|---|---|---|---|---|---|---|---|
| | | | A | B | C | B/A | C/B |
| Disbursed | 394.8 | 781.33 | 1,148.5 | 1,471.8 | 3,658.7 | 28.1 | 148.6 |
| Outstanding Debt | 2753.6 | 3304.5 | 7,318.8 | 8,846.3 | 10,185.1 | 20.9 | 15.1 |
| Multilateral | 1531.2 | 2029.1 | 3,480.9 | 4,001.1 | 4,721.9 | 14.9 | 18.0 |
| Bilateral | 946.7 | 1020.5 | 1,724.5 | 2,227.5 | 2,052.5 | 29.2 | -7.9 |
| Commercial | 275.8 | 254.9 | 2,113.4 | 2,617.7 | 3,410.7 | 23.9 | 30.3 |
| Debt Service | 76.8 | 86.3 | 204.5 | 391.8 | 781.9 | 91.6 | 99.5 |
| Principal repayments | 46.8 | 59.0 | 151.6 | 302.1 | 587.9 | 99.3 | 94.6 |
| Interest Payments | 30.0 | 27.3 | 52.9 | 89.7 | 194.0 | 69.7 | 116.2 |
| Debt Stock to GDP Ratio (in %) | 10.4 | 10.3 | 23.1 | 19.4 | 23.2 | -16.1 | 19.6 |
| Debt Stock to Export of goods & services | 0.9 | 1.0 | 1.4 | 1.5 | 1.7 | 8.2 | 16.0 |
| Receipt from goods & non-factor Services | 3063.2 | 3381.4 | 5,605.6 | 5,963.2 | 5,928.1 | 6.4 | -0.6 |
| Debt service ratio (%) | 2.5 | 2.6 | 3.6 | 6.6 | 13.2 | 80.9 | 100.0 |
| Relief | 28.2 | 18.7 | 8.4 | 7.9 | 7.9 | -5.5 | 0.0 |
| Principal | 24.1 | 16.9 | 7.8 | 6.7 | 7.1 | -14.1 | 6.0 |
| Interest | 4.1 | 1.8 | 0.6 | 1.2 | 2.0 | 106.7 | 61.3 |

*Source: NBE, Annual reports, various issues*

Despite the recent significant increase in external indebtedness of the country, the external debt level of the country is considered as sustainable. This was highlighted in the recent IMF's debt sustainability analysis on Ethiopia. Despite the increase in the present value (PV) of public and publicly guaranteed (PPG) external debt from 13.2% of GDP in 2011/12 to 14.4% of GDP in 2012/13 and that of the ratio of PV of PPG external debt to exports from 94.3 to 110.6% in the same period, as a result of the rapid build-up of external debt and low exports growth, the IMF considered Ethiopia as a low risk of debt stress (IMF, 2013). Yet, it warned "some of the large public investment projects by state-owned enterprises could pose risks to Ethiopia's public debt sustainability". So, it recommended careful monitoring of new debt accumulation especially commercial loan.

Given that the external debt level is still sustainable and the robust economic growth recorded over the last nine years, double-digit growth, Ethiopia could afford to borrow more from external sources on concessional as well as commercial terms to finance projects that could contribute to economic growth in the country. In the 2013 Debt Sustainability Report for Ethiopia, it was highlighted "Ethiopia can borrow up to USD 1 billion per year from other creditors on non-concessional or commercial terms as long as these loans finance projects that are growth enhancing."

In the recently launched Medium Term Debt Management Strategy (MTDS) for Ethiopia, external borrowing is highlighted as one of the biggest financers' of budget deficit in the medium term given the relatively low level of development in the domestic financial market (MoFED, 2012). While foreseeing an increased flow of external borrowing from multilateral, bilateral and commercial lenders, the strategy is aimed at ensuring a debt level consistent with macroeconomic stability, debt sustainability and the overall fiscal framework.

# 6 Key Country Risks to Financial Stability and Inclusive Growth

The stability of the Ethiopian financial sector depends on a number of factors including the macroeconomic environment, the foreign exchange situation, the business/regulatory environment, corruption, corporate governance, risk management, etc.

**Unpredictable inflation**: According to Thorat (2013) inflation and financial instability are the biggest threats to inclusive growth. Since, 2008/09, Ethiopia has become vulnerable to inflation arising from monetary policy mismanagement, supply rigidities, inflation expectation and the pass through from the global economic turmoil. This could affect the loan collection and disbursement activity of banks.

**Foreign exchange shortage**: Availability of foreign exchange is critical for banking business in Ethiopia as it affects lending especially for international trade and the interest income on foreign exchange deposits in correspondent banks. Over the last couple of years, the international reserve position of the country has dipped to around 2 months of import cover, which is well below the IMF recommended level of 3 months. Consequently, foreign exchange shortage has become the main feature of the Ethiopian financial sector, leading to queues in foreign exchange application for imports. This situation has been exacerbated recently due to the unstable and disappointing export performance.

Despite the Government's endeavour to increase the country's export earning to over 10% of GDP during the GTP period by pursuing concrete policy measures and incentive schemes, the overall export performance has been a big disappointment for the last three years in a row. Data from the Ministry of Trade revealed that revenue from exports declined to USD 3.075 billion at the close of 2012/13 when compared with USD 3.152 billion in the preceding year. The decline in the exports of coffee, gold, oil seeds, flower and livestock contributed for such overall decline in exports in the fiscal year. The key export earner of the country (coffee) experienced sluggish performance in 2012/13 with 15% decline in export receipts compared to the preceding fiscal year mainly due to the decline in prices. The annual average unit price has declined from USD 4.9 per KG in 2011/12 to USD 3.7 per kg in 2012/13.

Import continues to outpace the performance of exports over the last 12 months of 2012/13. Data from the NBE revealed that imports has grown by 6.2% to USD 11.5 billion over the last 12 months compared to 2.5% slowdown in exports, leading to the worsening of the trade deficit to USD 8.4 billion and thus greater risk to financial stability. Thorat (2013) argued that growth in the current account deficits in a period of exchange overvaluation (in real effective terms) is quite risky.

**Worsening business environment:** On account of intended and unintended consequence of government policies, the investment climate in Ethiopia is poor and deteriorating. This is evidenced by successive World Bank's Doing Business surveys. According to the latest information, the overall ranking of Ethiopia in the Doing Business survey fell in 2012 to 111$^{th}$ from 104$^{th}$ in 2011 out of 183 countries. As per the survey, getting credit, trading across borders, registering property and protecting investors emerge as the main constraints facing investors in Ethiopia (WB, 2012). On the financial sector side, the regulatory burden and the tightening of regulations are making the operating environment for banks quite difficult. The 27% NBE bill requirement has constrained the lending capacity of private banks. The increased capital requirements of banking business have made the entry into the banking sector quite difficult.

**Corruption:** Although difficult to properly quantify its magnitude, Ethiopia is observing rising corruption in a number of sectors including the Revenue and Customs, the Telecom, Ethiopian Electric Power Corporation, banks, etc. Unless concrete actions are taken to tackle the problem from its roots, this will lead to erosion of business confidence in the country.

**Weak risk management practices:** Risk management is getting attention in the financial sector in recent years. Each bank established a small unit to deal with risk management and in some banks we have seen risk management analysis in their annual report. Yet, there are capacity limitations in terms guidelines and risk management expertise. Banking business without a functioning risk management system is quite risky and could undermine the overall stability of the banking system.

**Other risk factors:** This could include lack of skilled manpower in the financial sector, lack of alternative financing mechanism; ineffective ICT infrastructure on account of very weak internet connectivity, lack of standardized accounting, auditing and reporting practices.

There are various channels through which these risks are transmitted into financial stability and inclusive growth. Unpredictable and high inflation could lead to misallocation of resources, slower asset growth, decline in real value of deposits, discourage savings and dampen demand for broad money (WB, 2013). This in turn could potentially lead to lower credit growth, lower profitability, lower tax intake and ultimately lower output growth. The worsening business environment could lead to weakening of economic activities and potential loan default. Although currently losses of banks are low, potential increase in loan default would affect the soundness of the banking sector. It will affect economic growth as it weakens lending capacity of banks and through this to lower profitability and lower tax intake.

The potential crowding out of private banks through the 27% NBE bill requirement would lead to tight liquidity and funding conditions for banks. This would affect banks performance in terms of credit growth and overall profitability. Lower profit would translate in to lower tax intake and then lower output growth.

International banking operation is one of the main sources of income for the banking sector. This is through interest income from correspondent banks and income from service charge from letter of credit and transfer services. Nevertheless, increased foreign exchange shortage would lead to loss of interest income and income from foreign exchange gain and service charges. This would affect the profitability of the banking sector. Foreign exchange shortage would also lead to lower lending to the private sector as most of the lending is associated with importing by the private sector. Lower lending would translate in to lower profitability, lower tax intake and lower output growth.

# 7 Conclusion

This study is intended to explore the link among financial inclusion, regulation and inclusive growth. The key questions that may open up avenues in exploring this link are: i) what is the trend in the structure and development of the financial sector; ii) how inclusive is the banking sector; iii) the relationship among financial sector regulations, financial stability and inclusive growth; iv) what is the role of capital flows in inclusive growth and how best it should be regulated; and finally, v) what are the key country risks to financial stability and inclusive growth.

In dealing with the financial inclusion we took two perspectives: the relationship between banking and inclusion on the one hand and how financial regulation impacts the size and composition of financial sector for financial inclusion. To analyse the relationship among financial sector regulations, financial stability and inclusive growth we focus on two main relationships: i) The relationship between the financial sector and inclusive growth and the mechanisms through which financial regulation affect this relationship; and ii) The relationship between the financial sector and financial stability and the mechanisms through which financial regulation influences this relationship. We now move on to sum up what has been undertaken in this study and what lessons arise out of the analysis and presents our reflection.

**On financial structures, size and performance**: The Ethiopian financial sector/policies have evolved through three stylized stages: first, financial repression and fostering state-led industrial and agricultural development through preferential credit (in the socialist regime); second, market-led development through liberalization and deregulation (post 1991); and third, financial inclusion through MFIs (since second half of 1990s). Following the Proclamation No. 84/1994, the country witnessed a proliferation of private banking and insurance companies. The establishment of microfinance institutions started with the promulgation of a proclamation in 1996 (no. 40/1996). The Ethiopian financial sector consists of 3 public banks, 14 private banks, 14 private insurance companies, 1 public insurance company, 33 microfinance institutions and over 8200 Saving and Credit Cooperatives (SACCOs) in both rural and urban areas.

The Ethiopian financial sector is not, however, diversified in terms of the type of institutions delivering the service and the type of financial products being delivered. There are no investment banks thus far and the financial service is dominated by a cash based system. Moreover, there is no stock market and the financial market comprising the interbank money and foreign exchange markets as well as the bond and TBs market is at an infant stage accommodating limited amount of transactions. The Ethiopian financial sector is highly regulated and closed from foreign competition.

**On financial inclusion**: Financial inclusion is on progress albeit from weak base. One important aspect of this trend is the progress achieved in expanding bank branches and areas of coverage. But a lot remains to be desired. Access is still a national issue. Less than 8% of Ethiopians have a bank account. The proportion of borrowers is even smaller. MFIs have reached only 14.5% of the households in the country.[31] It is observed that MFIs are not in a position to ensure continued financial access to SMEs and the poorer segments of society. MFIs do not have the financial capacity to meet the vast needs of the rural and urban poor. The overwhelming majority of rural people and urban poor have no access to financial services. The low-level financial institutions (cooperatives and credit unions) cannot also meet the credit needs of their members.

One of the major problems in enhancing financial inclusion is the lack/limited use of technology and innovation in financial service delivery. The NBE has issued different directives that encourage banks to use technology (core banking and channel banking). However, a lot remains to be desired. The basic problem for financial inclusion in general and technology based financial services in particular is the infrastructure problem. Core banking services and channel banking/technology based banking largely depends on IT and energy. In Ethiopia despite various efforts, there is serious and continuous frequent breakdown in mobile phone communication and energy. This has becoming more serious problem than ever before. Despite the government attempt to do its best to solve and create capacity, the problem still exists. One possible explanation for this might be the capacity utilization problem. The opinion is that telecommunication and energy sectors are in the monopoly of the government as a result there is lack of competition in these sectors which might be one reason for the poor capacity utilization and management in the areas.

To address these issues and broaden the financial inclusion, innovative mechanisms and proper institutional arrangement are required. To begin with, the infrastructure problem needs to be given prior attention. On the same line another basic issue, however, is the architecture of the financial sector. From our discussion with various stakeholders it seems that the linkage between the commercial banks and MFIs is critical where the former can dedicate a small amount of loans that can be disbursed and managed by the latter. There is also a need to link low level of financial institutions (SACCOs) with the MFIs. To recap linking SACCOs with MFIs and MFIs with commercial banks seems better architecture for the financial sector in order to have effective financial inclusion. This needs a clear direction, goal driven strategy and specific guideline at the national level. If so the financial fragmentation has to be addressed in a holistic manner.

**On financial regulations, stability and inclusive growth**: Deposit mobilization and provision of loan is constrained by physical access. Commercial banks are concentrated in big cities and towns (33.3% in the capital city alone). Thus, physical access is one of the major constraints to inclusive growth. The financial regulation has also adversely affect inclusive growth by discouraging more banks in joining the financial sector. The NBE issued a new directive that requires commercial banks to raise their minimum capital from Birr 75 million to Birr 500 million, which is 566% increase, as of September 2011. Furthermore, technology based banking is not yet developed in the true sense of financial inclusion. The regulatory institution has limited infrastructure to lead and expedite IT in the financial sector.

In addition to the physical access, access to the existing banks (particularly for SMEs, new and young firms) is also another problem for inclusive growth. This is due to banks' preference to large borrowers with large volume of transactions since it is easy to administer and the financial regulation that led banks to operate extremely through conservative lending policy (know your customer). In general, the credit policy of banks is like 'for the haves to have more'. Projects that qualify

[31] Wolday and Anteneh (2013:15).

this stringent credit procedure are constrained to get loan by collateral requirement. Nearly all loans require collateral and the value of collateral is higher relative to the amount of credit requested and granted. Currently projects that qualify the stringent credit procedures with high financial viability will require collateral at least 125% worth of the amount of loan requested.

The problem of access to credit has adversely affect inclusive growth and employment creation through limiting aggregate productivity growth and capacity utilization. Capacity utilisation for large and medium scale industries has been oscillating between the range of 46% and 55% mainly due to lack of access to finance. Lack of access to finance has also reduced aggregate productivity through allocative efficiency.[32] Limited access to finance affects productivity at the firm level through the conduit of allocative efficiency. The effect of problems associated with access to finance on allocation efficiency manifested itself in terms of lower fixed investment and net job creation rates.

Financial access is not only a problem of SMEs, new and young enterprises. Recently large and well-established enterprises have been also facing access problems due to the new financial regulation. The NBE bill introduced on 4 April 2011 required all private banks to invest 27% of their every new loan disbursements in NBE bills for five years at a very low interest rate, 3% in order to mobilise resources and facilitate access to long-term and large loans for government priority sectors. But what happened after this new directive is that more NBE bills follow provisions of short-term loans and this has exposed private banks to liquidity problems. To avoid more NBE bills, private banks shifted to long-term loans. This has led the NBE to introduce new directive that forces all private banks' short-term loans to constitute at least 40% of total loans in 2013. What makes matters worse is the change in the definition of short-term loans from up to 36 months maturity in the past to a maturity of only 12 months. This could lead to more funds be taken up by the NBE each time a short-term loan is advanced by banks and reduce the size loanable fund available at private banks. Banks are trying to cope with the adverse shocks of this new directive by increasing interest rate on loan and to mobilize deposits banks have increased interest rate on time deposits up to 10% as a means of quick deposit mobilization.

The GoE is trying its best to promote poverty reduction and inclusive growth by allocating resources to private sector through its special bank, DBE. DBE has been assisting the private sector by providing loans to priority projects with 8.5% interest rate, much lower from the market interest rate. The problem, however, is that the DBE has no diversified and enough sources to mobilise funds. The major source of loanable fund for the DBE is the NBE bill. But the amount of loan disbursed to private sector has increased marginally and the proportion of loan disbursed to private sector has decreased. What seems contradictory is that this happens immediately after the DBE has mobilised relatively huge resources through the NBE bill.

The NBE has always been active in trying to reduce ex ante and ex post risks for financial stability. The NBE's loan provision directive forces commercial banks to craft and work out Non-Performing Loan (NPL) reduction plan. This has brought the intended result. The NPL level which was as high as 6.8% in 2008, reduced to as low as 1.4% in 2012. The NBE has also issued various directives (reserve requirements, liquidity requirements, minimum capital adequacy ratio, minimum

[32] Allocative efficiency refers to the distribution of market share across the productivity spectrum of enterprises within the industry. If more resources and higher levels of output are allocated to more productive firms in the industry, the greater aggregate productivity and, in that sense, the higher the industry‘s allocative efficiency or competitiveness. (WB, 2009:6).

paid up capital and the like) in order to reduce ex ante risks and promotes banks' stability. The NBE has also issued directives to reduce ex post risks on loans. These are the maximum outstanding loan relative to the total capital, establishing a unit in the NBE that provide credit history services to commercial banks on individual applicant.

The other bank supervision mechanism which the NBE is trying to implement is the Basel Accord. The NBE is well in Basel I but does not have the required infrastructure to implement Basel II and III.

**On the role of capital flows**: The role of capital flows in the Ethiopian economy has been significant given the significant size of current account deficit that characterizes the economy. The capital inflow in the form of long-term loans has been instrumental in financing huge infrastructural projects and development of capacity building (human capital, administrative capacity, institutional building, and policy reforms). In has been financing import bills and investment and through this it has been influencing the growth of the economy positively. Private capital flow in the form of FDI has also been significant and growing. Other forms of private capital inflow such as portfolio equity flows, bond flows and cross-boarder bank lending are insignificant.

Given the importance of capital flows, the GoE has been taking measures to encourage long-term capital flows. This includes improving the operation of remittances, making the exchange rate more competitive, availing 70% of the capital for FDI investment in priority areas, providing land at lower tariff for commercial investors in agriculture, and providing land for free for the establishment of industrial zones in the country.

Encouraging long term capital flows without better ways of regulating it might result in a financial/economic crisis. To avoid this Ethiopia has been using different capital account management instruments. The current practice in Ethiopia is more towards quantity based capital account management instruments: prohibition, ceiling, or partial permit, etc. Real estate transactions abroad are prohibited, there is a ceiling on net exposure in foreign currency, foreigners are not allowed to invest in domestic securities, equity investment by foreign firms is strictly regulated, residents are not allowed to invest abroad, financial institutions are not allowed to borrow from abroad, external loan and supplier credit are allowed to exporters and FDI firms only.

However, given the huge financing requirements of the economy, Ethiopia can't afford to restrict capital flows in to the country by imposing strict capital control regime. The current capital account management regime should be revisited by authorities to loosen some of the restrictions. To this end, the following are worth to consider.

i) Foreign direct investment: Ethiopia should broaden the scope for FDI by allowing some sectors to gradually open their doors to foreigners. This could be in wholesale business, transport, financial sector, telecom, real estate, etc. The modality could be through a joint venture arrangement with Government or domestic private sector firms;

ii) Portfolio investment: Ethiopia has not benefited from equity financing thus far as there are restrictions. Given the recent rising interest towards equity investment by Shulze Global Investment and CDC, it is time for Ethiopia to reform the equity regulations that has been limiting foreign institutional investor ownership of share capital;

iii) External Loan and Suppliers Credit: Currently, only exporters and FDI firms are allowed to access external loan and suppliers' credit. This is considering their foreign exchange generation capacity, which could be used to repay those loans secured from abroad. Yet, such discriminatory measures continue to be criticized by import substituting firms;

iv) Profit repatriation by FDI firms: Given the keen interest to attract greater FDI, it would be beneficial if the current tight requirements regarding profit repatriation by non-resident firms be revisited;

v) Investment abroad by domestic firms: Restrictions on domestic firms to invest abroad should be loosened to allow some emerging firms gain global recognition and greater market access. But, such investments should be with a limit on amount to be invested and for selected sectors to which Ethiopian firms have comparative advantage; and

vi) Bank branch opening abroad: With the objective of mobilizing more foreign exchange from abroad, the state owned CBE was allowed to open branch in South Sudan. This is the first time that an Ethiopian Bank has started operation in a foreign country. Currently, such a privilege was not granted to private banks.

**On key country risks to financial stability and inclusive growth**: The country has key risks to financial stability and inclusive growth. These are related with the high GTP financing requirement, the macroeconomic environment, the foreign exchange situation, the business/regulatory environment, corruption, and risk management.

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# Appendix

Annex 1: List of interviewees

| | Name | Position | Institution | Date |
|---|---|---|---|---|
| 1 | Ahmed Abitew | Minister (Board chairman) | Federal Ministry of Industry (Development Bank of Ethiopia) | 14/2/2014 |
| 2 | Sintayehu Woldemichael | Director with the rank of Minister | Federal Public Finance Enterprise Agency | |
| 3 | Mohammed Seid | Deputy Director | Ethiopian Investment Agency | 14/2/2014 |
| 4 | Wolday Amha | Executive Director (board member) | Association of Ethiopian Microfinance Institutions (Commercial Bank of Ethiopia) | 25/2/2014 |
| 5 | Mola Mengistu | Vice President | Abay Bank | 21/2/2014 |
| 6 | Mulugeta Dilnesaw | Manager | Corporate Planning and Business Development, Nib International Bank | 15/2/2014 |
| 7 | Tsehaye Shiferaw | President | Awash International Bank | 24/2/2014 |
| 8 | Abebe Deressa | Manager | Planning Research and Development Department, Awash International Bank | |
| 9 | Yisak Mengesha | Chief | Business Development Officer, Commercial Bank of Ethiopia | |
| 10 | Getachew Mengiste | Chairman | Loan Approval Team, Development Bank of Ethiopia | 20/2/2014 |
| 11 | Muluneh Ayalew | A/Director, | External Economic Analysis and International Relations, National Bank of Ethiopia | |
| 12 | Frezer Ayalew | Director, | MFI Supervision Directorate, National Bank of Ethiopia | 24/2/2014 |
| 13 | Yenehasab Tadesse | Director | Foreign Exchange Control Directorate, National Bank of Ethiopia | |
| 14 | Merga Wakoya | Director | Bank Supervision Directorate, National Bank of Ethiopia | |
| 15 | Mezgebu Amha | Director | Macro Economic Policy and Management Directorate, Ministry of Finance and Economic Development | |
| 16 | Asfaw Abebe | Deputy Director | Federal Micro and Small Enterprises Development Agency | 16/5/2014 |

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