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Forum for Social Studies(FSS)

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Panel Presentation-led Public Dialogue onthe ongoing Revision of the Ethiopian Commercial Code and Liberalizing the Ethiopian Financial Sector: Panel Presentations' Summary

Background

Ethiopia's ambition to become a middle-income economy and deliver shared and sustained prosperity is driven by the government's Ten-Year Perspective Development Plan (2021 – 2030), which supplements the existing vision for a Home-grown Economic Reform agenda.

The country, however, faces significant challenges in this path, including high inflation rates and a long-standing debt and foreign currency crisis, among others.

To alleviate these problems, a gradual process of private-sector led liberalization has begun in some sectors, including in logistics and telecommunications, marking an important shift away from the largely state-led development pursued in recent decades.

The Ethiopian financial sector is one of the sectors that is prioritized under the Government's liberalization reform program, and it is reported that the Council of Ministers has recently approved the liberalization of the sector. If the bill is passed by the House of Peoples' Representative (HoPR), Ethiopia will open its financial market to multinational financial institutions.

While allowing foreign banks to operate in the country is not detrimental in and of itself, liberalizing the sector at this point in time will certainly have consequences for local banks as well as the entire economy. Thus, it is crucial to explore the pros and cons of liberalizing Ethiopia's financial sector and the lessons from other developing countries.

In a related development, a steering committee tasked with revising the country's commercial code in use since the 1960s E.C. is underway. So, what is the rationale of revising the code and what has been done so far and what is the way ahead?

To ensure a better understanding of the code revision process and explore the pros and cons around liberalizing the financial sector, Forum for Social Studies (FSS) organized a high-level panel-ledpublic discussion on Thursday, April 7, 2022, at Azzeman Hotel, Addis Ababa.

The panel consisted of: (1) Ato Belayhun Yirga, Director General, at the Ministry of Justice (MoJ); (2) Dr. Eyob Tesfaye, current board member of the National Bank of Ethiopia (NBE) and with a strong background in the Ethiopian financial sector; and (3) Professor Alemayehu, a macroeconomist and senior lecturer at Addis Ababa University (AAU), who has recently completed a study on Ethiopia's banking sector.

This policy brief is based on the presentations of the panelists and the discussion that followed. It is intended to summarize the core points raised and present policy recommendations to the government.

PART II: On the Intended Liberalization of the Ethiopian Financial Sector: Experiences of and Lessons from Similar Countries

Alemayehu Geda (Prof.)

1. Recent Trends in the African Banking Sector

As regards to bank ownership and efficiency in Africa, evidence suggests that the presence of larger foreign banks is usually associated with greater access to finance for small and medium scale enterprise. However, unfair competition can arise in cases where foreign banks disproportionally dominate the banking industry in terms of assets and branches(example, Zambia, studied in 2017). Foreign banks, with their capacity to obtain both hard and soft information about borrowers and businesses, can embark on anticompetitive schemes by "cherry picking" borrowers, while worsening the remaining credit pool for small domestic banks.

Thus, it is difficult to conclude whether foreign presence increases or decreases competition in the banking sector across the continent.

Operating expenses account for 5.4% of total assets in sub-Saharan Africa, whereas in North Africa, they account for 1.7%, close to the overhead cost of OECD countries of 1.5%, which indicates poor efficiency.

When we look at the financial innovation, while growing mobile banking and FinTechare seen to provide new opportunities for finance, they also bring new risks that need to be carefully monitored.

Ethiopia's performance in this regard has been the poorest in Africa.

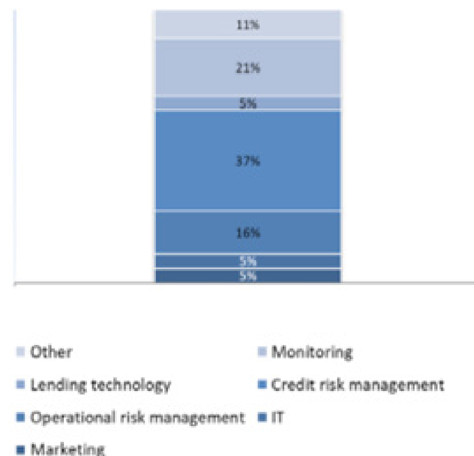
In terms of strategic focus, African banks have long-term focus on SMEs and on retail clients. Some 60% of banking groups focus on SMEs while 30% focus on retail clients, compared to 8% in 2016. The EBI's 2018 sample survey shows a declining focus on local large companies from one in four in 2016 (25%) to one in 10 in 2018 (10%). There was no focus on large multinationals.

2.Key Findings: Lessons from Financial Sector Liberalization in Developing Countries

The bulk of the evidence shows that envisaged results from financial liberalization (FL) in developing countries is not usually attained. Following liberalization most countries were exposed to financial instability. In 53 countries in Africa, between 1980 and 1995, 78% of all banking crises were linked to periods of financial liberalization.

a. Long-Term Market Focus

b. Technical Assistance Needs



Source: 2018 EIB survey of banking groups in SSA.

Scholars in the field and International Financial Institutions (IFIs) attribute such failures to wrong sequencing. However, studies show that wrong sequencing was not a major factor as there have been instances where crisis occurred with right sequencing.

Also, the advice that "crisis are short-term problems and you will be fine eventually" is a wrong advice as the likelihood of a banking crisis does not disappear, but increases over time. Asia has undertaken less financial reforms as compared to most developing countries in Africa but was successful.

The lesson from Asian success story are:

i. Gradualism and a step-by-step approach with a learning mechanism for swift correction;

ii. Financial literacy of government, banks, forecasters, academics and public; (lesson China draw from Scandinavian countries);

iii. Correct sequencing, especially macroeconomics stability (low inflation, fiscal and BoP deficit) before liberalizing the financial sector (a challenge for Ethiopia);

iv. Holistic and institutional approach that includes paying due attention to political implications and institutional requirements of the reform,

v. The role of a strong and informed state with able bureaucracy and ownership of the policy by all stakeholders (gov'ts, banks, the public, etc).

2.1. The Kenyan Experience

Before it decided to liberalize the sector in the late 1980s, Kenya had a financial sector structure similar to Ethiopia. The planned liberalization of the financial sector in Ethiopia, as can be seen in the Ethiopian-IMF agreement, is identical to that carried out in Kenya, including:

- Interest rate liberalization aimed at maintaining positive real interest rates/deregulation of interest rate – market-based interest rate,
- The establishment of secondary market, money market and capital market, and using indirect instruments by the central bank and government reliance on domestic bank borrowing,
- Transition to floating exchange rate etc. Exchanger rate liberalization and avoid entry barriers in future (such as through implementing WTO agreement). As a result of its decision to liberalize, Kenya's experienced a 10-year period of turbulence (between 1990 and 2000), that included the collapse of many banks in the country. Thanks to the correction measures taken, the problems encountered in this turbulent period of liberalization (through institutional building in the central bank since the early 2000's and infusing technological innovation in the last 20 years, since 2000), Kenya today has one of the most vibrant financial sectors.

Moreover, Kenya, today, has the highest rate of financial inclusion in the emerging world comparable with advanced countries.

It has 49 banks, 5 NBFIs and 4 Building societies. Most indicators of the banking sector's service quality standards are also very good.

However, ownership concentration, segmentation and declining rate of saving as well as declining lending to productive sectors such as manufacturing and agriculture remains a major weakness of the Kenyan banking sector.

Positive Results from Kenyan Liberalization:

- The expansion of both financial and NBFIs, capital market, etc;

- High liquidity in the banking sector;

- The liberalization of interest rates and exchange rates provided further avenues for local banks to compete with more established banks, and this proved to be an added stimulus for the entry of local banks;

- Deposit in banks increased by 15.7% and 26.4% during liberalization period in 1989-91 and 1992-1995. (Government deposit and demand deposit declined significantly, though).

Negative Results from Kenyan Liberalization

- Despite the interest rate liberalization since 1989, interest rate spread (b/n lending & saving rate) remained high. The initial positive real interest rate also quickly returned to negative;

- Interest rate increased (pushed by Treasury rate increase owing to gov't borrowing), government deposit declined, composition of deposit changed from demand (declined) to savings;

- Inflation worsened and real deposit rate became negative.

- Kenya's liberalization led to bank concentration which in turn led to (i) high lending rate (ii) which in turn led to high unwanted liquidity and (iii) hence market signals failed to work;

- The liberalization also led to bank crisis and bank liquidation, especially the indigenous banks (By 1992, 11 commercial banks and 20 NBFIs were experiencing financial distress)

- By 1996, 55 to 60% of the institutions were liquidated with the deposit protection fund. Between 1986 and 1998, Kenya saw the failure of 37 banks and NBFI (about 42% failure due to reasons that had to do with political connection and poor regulation. This stands in sharp contrast to the time before 1991 where there were 31 commercial banks and 57 NBFI (total 88).

- The related policy of liberalization of foreign exchange market and trade, on top of the interest rate deregulation, made regulators weak and unable to handle the challenge of the liberalization. Hence, the value of the Chinese wisdom noted: "Crossing the river by touching the stones".

Lesson

The lesson to draw from the experiences of the developing countries in Africa, Kenya in particular, is that there's no need to rush to liberalization before stabilizing the financial sector.

Before considering liberalization, the Government of Ethiopia needs to address issues such as inflation, to avoid mistakes as those in neighboring Kenya, which worsened the country's high inflation and made real deposit rate negative.

In the case of Kenya, despite the interest rate liberalization, since 1989 interest rate spread remained high. The initial positive real interest rate also quickly returned to negative.

This situation is strikingly similar to current Ethiopian situation where inflation is high, the Birr is depreciating quickly and the Government and the IMF are planning on attaining positive interest rate with liberalization of interest rate. Thus, it goes without saying that the outcome would also be similar – non-achievement of the intended result of efficiency.

Thus, upgrading the regulatory and supervision capacity at NBE is key to avoid Kenya-type post liberalization financial sector crisis. It is also worth noting that the related policy of liberalization, of foreign exchange market, and trade—on top of the interest rate deregulation—made regulators weak and unable to handle the challenges of liberalization.

The Ethiopian government will do well to avoid privatization of the state-owned banks – Commercial Bank of Ethiopia and Development Bank of Ethiopia, which have around 60 percent market share in the industry at the moment. Rather, it must keep these banks from failure and being transferred to or privatized by international financial institutions.

There is no single country that grew without development banking (China, Korea, Taiwan, Germany being some of the examples). It is in the national interest to have a healthy public banking sector as it is key for national development, hence the need to look at the bigger picture and ensure strong regulatory capacity.

3. Conclusion:

Follow the Chinesewisdom: "Crossing the river by touching the stones", i.e., learn as you go.

4. Strategic Policy Directions

4.1. Firm Level/Banking Sector

• Digitalization of the banking service for competitions among the local banks.

- Enhancing Digital banking, including signature and identification/video use (banking the unbanked through digitalization);

- Financial Sector literacy that includes the building risk management and marketing capacity (to ensure readiness to operate under a liberalized

market environment: e.g. exchange rate and interest rate risk management);

- Building a Strategic Portfolio Direction towards Small and Medium Enterprise (SMEs) and retail clients;

- Other Key Firm level Success Factors the Banking Sector Needs to Look at Before Opening Up (form experience in Developing countries, Least-developing countries including Kenya and Ethiopia)

- Providing customer services with: quality, reliability, flexibility, speed, low cost and strategic and speedy attendance to constraints while focusing on local knowledge.

- Striving to be “more than a bank” by providing value-added services, including peer-to-peer transactions (by learning from the experiences of banks in advanced countries)

- Formulating an internal marketing policy to influence employee job satisfaction which in turn influences customer service quality, satisfaction and loyalty with combined effect on profitability (There is empirical evidence for this in a study on Ethiopian Banks)

- Ensuring efficient human resource management and continuous training on management, marketing, service delivery as well as wide acceptance across banks, regions, and eventually worldwide (learning from the experiences of banks in advanced countries).

Four Firm-Level Medium-term Strategic Directions to work out, say, in the next five years:

a. Investment banking: Accepting and discounting bills of exchange; corporate finance [equities, mergers & acquisitions-moving beyond ethnic banking; research]; Investment management; handling loan agreements including foreign borrowing on behalf of local firms etc.]

b. Derivative Products: such as ‘future buying options, at price agreed now’, ‘handling borrowing at floating interest and exchange rate’

c. Trading on public sector bonds/bills and trading on foreign exchange: such as operating FX bureaus; buying and selling T-bills etc.

d. Trade Finance beyond Payment Service: such as foreign exchange options; trading guarantees, say, quality and others; introducing other services such as market intelligence and working with EXIM banks,e.g..Afrexim bank is also recommended.

4.2. Government/ Macro Level Strategic Policy Directions:

- First and foremost, the government needs to ensure comprehensive macro stability, addressing the issue of inflation is a particularly key precondition (failure to do so may result in pushing the lending rate up from 35 to 50% minimum, as Kenya’s experience shows);

- It is very important to note here that controlling inflation is achieved through increased food supply and ensuring exchange rate stability in a country where the markets do not exist or are inefficient, if they do so, as to allow monetary instruments to be effective; and

- Also note that BOP deficit: liberalization of the market for FX (and interest rate) is not a solution, as this can quickly result in the government losing control of the economy and should be implemented cautiously; aggressive exporting is key (giving attention to strategies such as cluster farming).

- Specifically, gains in trade liberalization are more likely to be realized when a government enjoys a strong balance of payments position; trade liberalization in the context of balance of payments pressure can lead to severe macro instability;

- Successful liberalization shows gradualism (step-by-step move) as key success factor. Pressure needs to be applied to push government towards that.

- Upgrading the regulatory and supervision capacity at NBE is key to avoid Kenya-type financial sector crisis which occurred following liberalization (internal debt problem due to NPL, banking crisis etc.);

- The government of Ethiopia needs to watch out for development-oriented banks (CBE and DBE) so as to keep them from failure and privatization by IFIs.

- There is no single country that grew without development banking (China, Korea, Taiwan, Germany being some of the examples). It is in the best interest of the country to have a healthy public banking sector as it is key for national development.

- Finally, establishing a government-led Financial Sector Task Force to decide (a) time span of liberalization (b) prioritize and apply plan of what to liberalize first, second, etc. (c) Check if NBE has capacity for each step & item of liberalization (d) learn from this for further liberalization. This will ensure the country to cross the river like the Chinese did.

(Compiled by Abera Woldekidan, FSS Media and Communications Specialist, on the basis of video-audio recordings)