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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.

Liberalizing the Ethiopian Financial Sector Presentation III

By Eyob Tesfaye (PhD)

Broadly defined, financial sector liberalization is a process allowing markets to determine who gets and grants credit, and at what price. The process also entails opening up the market for foreign banks to operate. In recent times, financial sector reform and financial liberalization have garnered considerable attention because the financial sector is regarded as a key instrument for development, and therefore has the role of mobilizing scarce resources in terms of saving and translating them into investment, economic development, and job creation.

Since the 1990s, there have been efforts by governments across the world to liberalize their financial markets. However, a closer look at the experiences of countries that opted for liberalization, particularly developing countries, reveals that the results have been detrimental.

For instance, in Latin America, in countries like Argentina and others where Spanish banks were allowed to operate in acquisition and merger services, liberalization triggered a macro-economic crisis, financial sector crisis and banking crisis. Similar experiences can also be cited from countries in Eastern Europe and Asia.

This presentation 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.

When it comes to financial sector development, it is primarily measured in terms of ‘financial deepening’. This is a concept that refers to an increased provision of financial services and generally means an increase in the ratio of money supply to GDP. The success of financial deepening differs from country to country, and from continent to continent, depending on various factors. When we look at the case of African countries, Kenya’s financial deepening is around 40 and 45, for example. In Ethiopia, it is 35, with the private sector’s contribution to GDP at 18, which reflects the country’s poor financial depth.

Ethiopia’s financial sector, trade, cash flow, development banking system and foreign investment indeed remain underdeveloped. The presence of a stock exchange and foreign banks represent some of the prerequisites for, and determinants of, the levels of foreign investment in a given country. In Ethiopia, there is no such stock exchange or foreign banks to facilitate and attract foreign investment to the country.

The lack of foreign banks in the country means the system remains isolated from the effects of globalization, while policymakers fear that liberalization will lead to loss of control over the economy. The government controls interest rates and sets them below the high inflation rate. Corruption, though strictly sanctioned, remains a concern. While the National Bank of Ethiopia is the country’s central bank, the state-owned Commercial Bank of Ethiopia is the largest bank in the country, controlling 2/3 of the assets of the entire banking system. The Central Bank has a monopoly on all foreign exchange transactions and supervises all foreign exchange payments and remittances.

Financial sector liberalization started in Ethiopia in 1992, with a rather cautious approach. There are now about 22 banks, 19 insurance companies, and 30 micro-finance institutions, with a total deposit amounting to 1.7 trillion ETB, and a total loan of 1.6 trillion ETB. Financial institutions and services are limited to urban areas, and there are a total of 7,000 branches for the country’s more than 110 million people, meaning Ethiopia is one of the most under-banked countries in Sub-Saharan Africa in terms of the ratio of bank coverage to population size. As such, the Ethiopian financial sector remains rather closed and underdeveloped, compared to other neighboring countries. Owing to this lack of effective competition in the financial sector — from both domestic and international markets— the performance of the sector and its services remain underdeveloped in terms of quality and coverage.

Recently, however, a Treasury Bills Market has been launched, pointing towards a step in the right direction. With Treasury Markets, interest rates are determined by the market. Another positive measure taken in Ethiopia is the introduction of a capital market, which countries around the world, particularly developing countries, do to mobilize resources and large capital investments. Though this endeavor takes time, it is positive that the country has already begun this path.

Recently, government banks, and to some extent, private banks, are playing an important role in shouldering the national economy. The contribution of state-owned commercial banks in particular has been instrumental to development initiatives, such as the financing of capital-intensive projects including the Great Ethiopia Renaissance Dam. This process, however, has not been flawless. To begin with, funds have been provided in the absence of feasibility studies, and without project and contract management capacity. This has resulted in the some of the loans becoming ‘bad loans’.

To address this gap in the financial sector, the government has established a Liability and Asset Management Company, which will serve the country’s key financial sector. Yet, in some state-owned banks— and to some extent private banks, where there is a lack of credit analysis capacity— money was channeled to unproductive investments instead of productive ones, contributing to the rise of inflation prevailing in the country.

It is important to see why countries liberalize their markets to allow foreign banks to enter their financial sector. It is generally believed that opening up one’s market allows for foreign participation in enhancing financial intermediation and economic growth, but when we see the experiences of some countries in Asia and Latin America that went through liberalization in a fragile environment, they were not successful in attracting foreign investment and achieving efficiency gains.

For example, countries such as China and Vietnam, where they went through a fragile approach, have not been successful in achieving the much-desired efficiency gain and investment expected. In Eastern Europe, state-owned banks did a 100 % liberalization hoping to find the much-needed foreign expertise, but this didn’t happen. In Latin America, Argentina, Chile, Mexico, and to some extent Brazil, liberalization resulted in a macro-economic crisis. The same is true for African countries where foreign banks only entered to serve the interests of their own companies. Indeed, some 30 countries in Sub-Saharan Africa, such as Mozambique and Madagascar, have not been able to secure the efficiency promised by liberalization.

In any case, efficiency gain differs from country to country, and from continent to continent. What matters is how well you manage it. Compared to neighboring and other African countries, Ethiopian financial sector performance is ranked at the bottom end. The banking sector is overwhelmed by the semi-monopolistic state-owned Commercial Bank of Ethiopia. The majority of the population remains underserved and financial institutions such as banks, insurance and microfinance institutions are still highly concentrated in urban and semi-urban areas where less than 10% of the population resides.

into the country. This is because the financial sector plays an important role as it is the crucial link to trade in achieving much-needed efficiency gains. The most important argument that supports financial liberalization is to improve financial development and get higher economic growth. Financial liberalization in the banking sector is usually done with the view to increase the efficiency of banks, improve the allocation of credits, stimulate savings, and, subsequently, attain higher economic growth. On the flip side, however, financial liberalization increases the likelihood of banking crises, especially in conditions of weak regulation and supervision capacity.

The development of a viable domestic banking sector will be threatened by foreign banks because the latter have more capital, more experience, and better resources. Evidently, Ethiopia's financial sector is too nascent and inexperienced to compete with international banks.

Moreover, the entry of foreign banks will further skew credit allocation towards large-scale, industrial, real estate, and service enterprises (including trade), and away from agriculture, small-scale, and cottage/micro-enterprises. Additionally, foreign banks will not only "cherry-pick" the best companies and sectors, but they will likely concentrate lending in major urban centers using foreign funds, contributing little towards the development of rural banking.

Domestic savings mobilization is also an area of concern because foreign banks would lend in foreign currencies and would not be interested in mobilizing domestic savings. In addition, there are concerns that foreign banks may serve as conduits for the inward and outward flows of capital (e.g. through capital and money-market transactions, credit operations, personal capital movements, etc.). This may result in foreign exchange and/or liquidity shortages, with potentially adverse effects on the country's capital account. The concern becomes more pronounced given the limited regulatory capacity of the central bank. Hence the need for authorities to regulate and supervise foreign banks effectively.

Financial sector liberalization will not succeed in the absence of effective government regulation, or appropriate macroeconomic, financial and institutional stability. This is an area where care and caution is required from the government because without assurances, the idea of liberalization cannot be viable.

Without the necessary preconditions, financial liberalization would result in macro-economic and financial crises, as has happened in most developing and emerging countries. Financial liberalization does not mean that the government will completely ignore the financial sector, but rather, that direct government involvement has to be limited to building an appropriate environment for the effective functioning of the sector. The government has to establish an effective regulatory institution to provide oversight of the effective functioning of the sectors.

Conclusion

Learning from the experiences of other developing countries in Asia, Latin America and Africa, complete financial liberalization must be out of the question. Complete liberalization would mean giving away a key development instrument to foreign banks, which can disrupt the country's economic activities and overall development endeavors. Governments should pay close attention and concentrate on effective regulation of the sector.

As things stand, liberalizing Ethiopia's financial sector will do more harm than good. There is a lot of work that first needs to be done, such as macroeconomic stability, controlling inflation, and building adequate regulatory capacity. To some extent, allowing equity banks may be timely, and can better be done based on research to explore the ramifications on the local economy in terms of development, financial deepening, access to finance, financial inclusion, and even job creation.

Recommendations

1. The most important factor for securing macro financial stability is managing inflation, a major challenge without which it is impossible to do much. More than just increasing food supplies, a long-lasting solution is required.

2. Liberalization allows foreign banks to enter the Ethiopian financial market, so there should be a clear road map for opening the sector beforehand.

3. A task force, or a council advising the government on this aspect, must be transparent.

4. Along with financial liberalization, there must be a strong deposit insurance scheme as the public needs insurance for the money deposited in these banks.

5. The bottom line is that the central bank, which is the supervisory authority, must have the supervisory capacity that matches the high quality of services and products with which the foreign banks would come.

6. Therefore, creating a robust supervisory capacity is something to be done right NOW, and not after the foreign banks have entered the market, the same way as it would be unwise to start to study geology after an earthquake occurs.

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