ETHIOPIAN BANKING SYSTEM

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Abstract

This study is on the Ethiopian banking system. Ethiopia may be listed among the longest surviving states in the whole world and has been able to preserve more than any other country in the African continent its own national identity. Unlike in other African countries, the distinguishing imprint of a single colonial power is hardly noticed. This paper has examined the history of the Ethiopian banking system. Particular attention is given to the Central Banking System, Organisation, Regulation/Supervision and the Monetary Policy Framework of the nation. The study also examines the banking reform which aims at casting light on the changes in the country's banking sector, bank concentration, competition, efficiency and liquidity. Assessment of changes in the banking sector reveals that the sector has become less concentrated. However, competition among banks is weak, which is manifested through operational inefficiency and accumulation of large stock of liquidity. This has led to persistence of lack of access to bank loan even after the reform. In general, despite the introduction of banking sector reform in 1994 that led to expansion of the banking industry, the problem of credit access has persisted. Policy makers should therefore devise mechanisms that enhance competition in the banking sector and establish a policy framework that encourages them to lend to all sectors of the economy.

Key words: Ethiopian financial sector, banking reform, manufacturing sector, credit access, monetary policy framework.

History

February 15, 1906 marked the beginning of banking in Ethiopia when the first Bank of Abyssinia was inaugurated by Emperor Menelik II. It was a private bank whose shares were sold in Addis Ababa, New York, Paris, London, and Vienna. One of the first projects financed by the bank was the Franco-Ethiopian Railway which reached Addis Ababa in 1917. In 1931, Emperor Haile Selassie introduced reforms into the banking system. The Bank of Abyssinia was liquidated; the newly established Bank of Ethiopia, a fully government-owned bank, took over management, staff and premises of the ceased bank. The Bank of Ethiopia provided central and commercial banking services to the country (Mauri, 2010). The Italian invasion in 1935 brought the demise of one of the earliest initiatives in African banking. During the Italian occupation, Italian banks were active in Ethiopia.

On April 15, 1943, the State Bank of Ethiopia became the Central Bank and was active until 1963.The National Bank of Ethiopia was established in 1963 by Proclamation 206 of 1963 and began operation in January 1964. The establishment of the new organization was aided by U.S

Department of State emissary, Earle O. Latham, who was the first Vice President of the Federal Reserve Bank of Boston.

Prior to this proclamation, the bank carried out dual activities: commercial banking and central banking. The proclamation raised the bank's capital to 10 million Ethiopian Dollars and granted broad administrative autonomy and juridical personality. Following the proclamation, the National Bank of Ethiopia was entrusted with the following responsibilities:

- To regulate the supply, availability and cost of money and credit.
- To manage and administer the country's international reserves.
- To license and supervise banks and hold commercial banks reserves and lend money to them.
- To supervise loans of commercial banks and regulate interest rates.
- To issue paper money and coins.
- To act as an agent of the Government.
- To fix and control the foreign exchange rates.

However, monetary and banking proclamation No. 99 of 1976 came into force on September 1976 to shape the bank's role according to the socialist economic principle that the country adopted. Hence the bank was allowed to participate actively in national planning, specifically financial planning, in cooperation with the concerned state organs. The bank's supervisory area was also increased to include other financial institutions such as insurance institutions, credit cooperatives and investment-oriented banks. Moreover the proclamation introduced the new 'Ethiopian birr' in place of the former Ethiopian Dollar that ceased to be legal tender.

The proclamation revised the bank's relationship with Government. It initially raised the legal limits of outstanding government domestic borrowing to 25% of the actual ordinary revenue of the government during the proceeding three budget years as against the proclamation 206/1963, which set it to be 15%.

This proclamation was in force till the new proclamation issued in 1994 to reorganize the bank according to the market-based economic policy so that it could foster monetary stability, a sound financial system and such other credit and exchange conditions which are conducive to the balanced growth of the economy of the country. Accordingly, the following are some of the powers and duties vested in the bank by proclamation 83/1994:

- Regulate the supply and availability of money and credit and applicable interest and other changes.
- Set limits on gold and foreign exchange assets which banks and other financial institutions authorized to deal in foreign exchange and hold in deposits.
- Set limits on the net foreign exchange position and on the terms and amount of external indebtedness of banks and other financial institutions.
- Make short and long-term refinancing facilities available to banks and other financial institutions.

Lastly, the proclamation has also raised the paid-up capital of the bank from Birr 30.0 million to Birr 50.0 million. The National Bank of Ethiopia is one of the original 17 regulatory institutions to make specific national commitments to financial inclusion under the Alliance for Financial Inclusion's (AFI) Maya Declaration (Maya, 2011).

Commercial Bank of Ethiopia

The **Commercial Bank of Ethiopia** (**CBE**) is the largest commercial bank in Ethiopia. As at June 2011, it had about 86.5 billion Birr in assets and held approximately 63.5% of deposits and about 38% of all bank loans in the country. The bank has around 8,000 employees, who staff its headquarters and her over 500 branches positioned in the main cities and regional towns. The latter include 45 branches in the national capital Addis Ababa. With the opening of a branch in Gechi in the Illubabor Zone of the Oromia Region, CBE's banking network has reached 550 branches.

In 1963, the Ethiopian government split the State Bank of Ethiopia (est. 1942) into the National Bank of Ethiopia, the Central Bank, and the Commercial Bank of Ethiopia (CBE) (Brimmer, 1960). In 1958, the State Bank of Ethiopia established a branch in Sudan that the Sudanese government nationalized in 1970 (Mauri, 2008). The government later merged Addis Bank into the Commercial Bank of Ethiopia in 1980 to make CBE the sole commercial bank in the country. The government had created Addis Bank from the merger of the newly nationalized Addis Ababa Bank, and the Ethiopian operations of Banco di Roma and Banco di Napoli. Addis Ababa Bank was an affiliate that National and Grindlays bank had established in 1963 and of which it owned 40%. At the time of nationalization, Addis Ababa Bank had 26 branches.

In 1991, when Eritrea achieved its independence, CBE lost its branches in Eritrea to nationalization. These branches formed the base for what became in 1994, the Commercial Bank of Eritrea. Also in 1994, the Ethiopian government reorganized and re-established CBE.

A few years ago, the government restructured CBE and signed a contract with Royal Bank of Scotland for management consultancy services. After the death of its former President, Mr. Gezahegn Yilma, the Board of Management appointed Mr Abie Sano as a new President of the Bank. Parliament recently increased the Bank's capital to 4 billion Ethiopian Birr. At some point, CBE had a branch in Djibouti that it has since closed.

In January 2009, CBE received regulatory approval to open a branch in Juba, Southern Sudan (Hilina, 2009).

The Ethiopian Banking System

According to the Directive No. FXD/31/2006 (Amendment to Directive No. FXD/25/2004)

Establishment and Operation of Foreign Currency Account for Non-Resident Ethiopians and Non-Resident Ethiopian Origin.

To create incentives for Ethiopians in diaspora to maintain foreign currency account at home country so as to encourage domestic investment; and, in view of the fact that operation of foreign currency account by non-resident Ethiopians can support the international foreign exchange reserve and ease the balance of payments problem of the country; allowing Ethiopians abroad to open foreign currency account could encourage foreign direct investment, in accordance with Articles 6 and 61 of the Monetary and Banking Proclamation No. 83/1994, the National Bank of Ethiopia amends Directive No. FXD/25/2004 issued on the establishment and operation of foreign currency account for non-resident Ethiopians in domestic commercial banks.

Article 1: Definitions.

For the purpose of these Directives, unless the context provides otherwise,

1.1 “Non-resident Ethiopians” shall mean:
a) All Ethiopian nationals living and working abroad for more than one year.
b) Business entities owned by non-resident Ethiopians and located outside the Ethiopian territory for more than one year.
c) Ethiopian nationals living and working abroad or in due process of leaving abroad for work for more than one year and who can produce authenticated documents.
1.2 “Non-Resident (NR) Foreign National of Ethiopian Origin” shall mean
a) A non-resident and holder of a valid identification card, obtained pursuant to Proclamation 270/94, attesting that he/she is a foreign national of Ethiopian origin.
b) A business entity owned by non-resident foreign nationals of Ethiopian origin and located outside the Ethiopian territory.
1.3 “Non- Resident (NR) Foreign Currency Account” refers to the two types of account stated under Article 4 of this Directive and maintained in foreign currency by the debit of which funds can be transferred abroad and/or used locally without any permit from the Bank.
1.4 “Opening Banks” are authorized commercial banks in Ethiopia.
1.5 “The Bank” is the National Bank of Ethiopia.
1.6 "The account" is a foreign currency account opened by non-resident Ethiopians or foreign nationals of Ethiopian origin.
1.7 “Certificate” means commercial banks’ deposit certificate issued to the depositor in recognition of his/her ownership of the deposited sum of money.
1.8 “Foreign Currencies” refer the three types of currency indicated under Article 5 of this Directive and which the Bank accepts for purposes of foreign exchange.
1.9 “Deposits” shall mean foreign currency deposits received by the opening bank. They shall also include cash certificate, cheque or other deposits of similar nature.

Article 2: Eligibility Criteria.
2.1 The following individuals and/or enterprises may open a foreign currency account in any of the authorized commercial banks in Ethiopia:
a) Non-Resident Ethiopian.
b) Non-Resident Foreign Nationals of Ethiopian origin.
2.2 Non-Resident Ethiopians/foreign nationals of Ethiopian origin shall present the following documents to open an NR Foreign Currency Account in domestic banks.
a) Application forms properly filled and signed by the account holder.
b) For individuals, valid passport and/or identification card of foreign nationals of Ethiopian origin of the applicant.
c) For businesses, certificate of ownership entitlement for the organization and/or article and memorandum of association.
2.3 Applicants who could not be physically present to open the NR account in the domestic banks shall use the Ethiopian Embassies, correspondent banks or remittance service providers nearby to prove their identities.

Article 3: Opening Foreign Currency Account.
3.1 A foreign currency account may be opened for individuals and/or enterprises that fulfil the eligibility criteria set under Article 2 (2.1) of this Directive.
3.2 Persons residing abroad can open such accounts in person or by post in his/her name. Opening banks may also establish contact with potential account openers using e-mail, fax, telex and/or other electronic media authorized by the Bank. The bank should, however, receive authenticated documents afterwards to open the accounts.
3.3 A request for opening an account for deposit in foreign currency shall be accompanied by a letter of application and a specimen signature.

3.4 An individual and/or enterprises may open all or one of the foreign currency accounts enumerated under Article 4 (4.1) of this Directive.
3.5 Power of attorney holders are not allowed to open foreign currency accounts and credit the account on behalf of non-residents and/or foreign nationals of Ethiopian origin. However, power of attorney holders are allowed to withdraw from these accounts for the purposes enumerated in Article 7.1 of this Directive in addition to investment purposes provided that the document explicitly empowers them to operate the accounts.
3.6 The minimum amount required for an initial deposit to open current accounts shall be USD 100 or its equivalent in any of the eligible currency under Article 5 (5.1) of this Directive.
3.7 The minimum amount required in an initial deposit to open a fixed deposit foreign currency account shall be USD 5,000 or its equivalent in any of the eligible currencies under Article 5 (5.1) of this Directive.
3.8 The maximum amount to be deposited in current accounts shall be USD 50,000.
3.9 Two or more eligible joint depositors may together open a single account.
3.10 An individual may open current account in only one of the domestic banks whereas he/she may open fixed deposit accounts in more than one bank.

Article 4: Types of Permitted Account.
Commercial banks may open the following types of non-resident foreign currency accounts:
a) Fixed (time deposit) account, which takes the form of a deposit certificate, issued in the name of the depositor. Maturity period may vary based on the agreement made between the depositor and the opening bank. However, the minimum maturity period for such an account shall be three months.
b) Current account, which takes the form of current deposits where withdrawals may be made at any time upon demand by writing a check and/or a pre-arranged procedure adopted by the opening bank.
c) Non-repatriable Birr account which may take the form of saving deposit that can be used for local payments only.

Article 5: Types of Currency.
5.1 Banks are required to maintain foreign currency accounts in the following types of currency only:
a)The US Dollar,
b) Pound Sterling and
c) Euro
5.2 Banks may accept deposits in other convertible currencies that include Canadian Dollar, Saudi Riyal, Japanese Yen, Australian Dollar and UAE Dirham. These other currencies shall be converted to any of the three currencies enumerated under Article 5.1 at spot exchange rate based on the preference of the account opener.

Article 6: Crediting the Account.
6.1 A foreign currency account opened by non-resident Ethiopians shall be credited only with resources' transferred or originated from abroad in one or a combination of the following ways:
a) Direct crediting of the account from foreign sources through the banking system.
b) Traveller's cheques brought by the account holder from abroad.
c) Cash notes provided that the account holder presents a signed and sealed foreign currency declaration form from the Customs Authority.
d) Check deposits that originate from abroad.
e) A transfer from another type of non-resident foreign currency account owned by individuals and/or enterprises.

f) Receipt through international payment cards/credit cards.

Article 7: Use of the Account.

7.1 The foreign currency accounts may be used:

a) To make local payments in Birr.

b) To transfer to other foreign currency accounts, which may include transfer to another foreign currency accounts in any of the authorized commercial banks in Ethiopia.

c) To make foreign payments such as import and other foreign service payments provided the account holder has the required business license to do so.

d) To effect transfer abroad.

e) To convert into a Birr account at the ruling exchange rate.

f) Payments for bank charges, if any, levied by the opening bank.

g) To serve as collateral or guarantee for loans or bids.

7.2 Current accounts may be withdrawn against a cheque written and a withdrawal slip or according to any other pre-arranged procedure.

7.3 Opening bank maintaining these accounts shall allow repatriation abroad of the deposits opened in any of the account stated in Article 4 a and b of this Directive upon the request of the account holder.

7.4 Repatriation of the deposits shall not exceed the initial balance plus any interest receipt on the deposit amount.

Article 8: Closure of the Account.

8.1 A fixed deposit foreign currency account stated under Article 4 of this Directive can be closed upon request by the depositor with a prior notification of not less than 7 working days. Withdrawal of the fund prior to maturity is subject to interest penalty.

8.2 If a fixed deposit is not closed on maturity, the opening bank in consultation with the depositor may renew it.

8.3 A fixed account may be withdrawn against the deposit certificate and the specimen signature previously left with the bank or according to pre-arranged procedure.

8.4 A foreign currency account will be closed if the fund transferred to the account is found to be through money laundering or from terrorist financing services.

Article 9: Interest Rates.

9.1 Interest shall not be paid to a non-resident foreign currency current account.

9.2 Commercial banks are allowed to set their own interest rate on non-resident fixed foreign currency account provided that the interest rate does not exceed the prevailing LIBOR rate.

9.3 Interest on a non-resident fixed foreign currency deposit shall be payable only if they are kept for a minimum period of three months.

9.4 Payment of interest on fixed deposit maturing on Saturday/Sunday/holiday/non-business working day shall be determined based on the succeeding working day.

9.5 Interest rate payment on non-repatriable Birr accounts shall be double of the minimum saving deposit rate set by the NBE.

Article 10: Issuance of Certificate.

10.1 The opening bank shall issue to the depositor a fixed deposit certificate in depositor’s name if the established account is a fixed account.

10.2 The interest rate that the opening bank agrees to pay shall be clearly stated on the deposit certificate.

10.3 For a current account, the opening bank shall issue to the depositor a chequebook or an advice notifying of the opening of the account.

10.4 In the case of Article 3.2, the certificate of deposit (CD), or a chequebook may be kept in the custody of the opening bank and a certificate of custody shall be issued to the depositor or the deposit book may be sent to the depositor through post if he/she wishes to do so.

Article 11: Conversions of Non-Resident Foreign Currency Accounts to Resident Birr Account

11.1 When non-resident Ethiopians change their permanent residence to Ethiopia, their non-resident forex account shall be converted to resident Birr account at the prevailing inter-bank exchange rate by the opening bank; or

11.2 For fixed deposit, the account may remain as non-resident foreign currency account if the account holder returns to Ethiopia for permanent settlement before the maturity date of the account. Upon maturity of the account, however, such deposit should be converted to resident Birr account.

11.3 Provision of Article 7.1(e) of this Directive shall apply if requested by the account holder.

Article 12: Prohibitions.

12.1 Foreign exchange acquired either from forex bureaus or any other local sources or foreign exchange held locally shall not be used to credit and/or open a foreign currency account.

12.2 Opening banks shall not honour cheque drawn or endorsed by a non-resident foreign currency account holder in favour of a resident who does not hold similar non-resident foreign currency account.

Article 13: Obligations of the Opening Bank.

13.1 The-opening bank has the following obligations:

a) It shall be responsible for maintaining confidentiality of the account of the depositor

b) It shall send a report based on the attached format every month to the Banking and Foreign Exchange Directorate and Economic Research and Monetary Policy Directorate of the Bank within 20 days after the end of each month

c) The overall open foreign currency position of each bank at the close of each business day shall not exceed 15% (fifteen percent) of its total capital as per the Directive No. SBB/23/97.

Article 14: Provision of Incentives.

14.1 The deposit account can serve as collateral to get credit in local currency from domestic banks in line with the opening bank's credit policy.

14.2 Interest income on non-resident foreign currency fixed deposit account shall be free from income tax.

14.3 In addition to the above incentives banks shall create the following conducive environment for account holders.

14.3.1 Banks shall provide statement of the account every month to the account holder.

14.3.2 Banks shall create Test-Key so that the account holder can order withdrawals and/or any local payments.

14.3.3 Banks shall credit interest to the accounts at least on quarterly basis.

14.3.4 Banks shall create a mechanism where by the account holder can make a standing authorization to the opening bank for permanent payments.

14.3.5 Banks shall clearly list out their correspondent banks or agents in various overseas centres, which are in operation of foreign currency account to enable non-resident Ethiopians to easily contact them.

Article 15: Inspection.

The Bank may undertake inspection of any opening bank at any time to verify that the opening bank complies with the provisions of this Directive.

Article 16: Penalties.

16.1 Any bank that violates any of the provisions of this Directive shall be subject to penalties in accordance with the Licensing and Supervision of Banking Business Directive No.SBB/27/2001.

16.2 Any bank that fails to comply with the reporting requirement specified under Article 13.1 (b) shall pay a penalty of Birr 1,000 per day of delay. The penalty so assessed will be automatically deducted from the bank's account maintained with the NBE.

16.3 Where an account holder violates the provision of this Directive, the opening bank may suspend the account and immediately report the case to the Bank.

Article 17: Repeal.

Regulation related to the establishment and operation of foreign currency account for non-resident Ethiopians and non-resident Ethiopian origin issued under directive No. FXD/25/2004 is hereby repealed and replaced by directive No. FXD/31/2006.

Article 18: Miscellaneous Provisions.

This Directive entered into force on the 28 August 2006.

Note: The above are most of the involvements in the Ethiopian banking system.

Bank Regulation and Supervision

Bank Supervision Directorate Information Kit (Brochure)

1. **Major Objectives of the Directorate:**

To ensure:

1.1 Safety & soundness of the banking sector.

1.2 Efficiency & compliance of banks with rules & regulations.

1.3 Protection of depositors' interest.

2. **Types of Service Delivered to Customers**:

2.1 **Issuance of Banking Business License**

a) Conditions required to open a blocked subscription bank account:

- pre-filing meeting with organizers,
- written application for opening a blocked subscription bank account,
- curriculum vitae including names, addresses and occupation (including dates and addresses of employment covering the latest 10 years) of organizers,
- acceptance on bank's proposed "name" from Ministry of Trade,
- organizers' bylaws,
- last audited financial statements of businesses owned or managed by organizers (if any),
- properly signed minutes of organizers' meeting to establish a bank; and
- prospectus for subscribing shares.

b) Additional pre-conditions of licensing:

i written application for banking business license,

ii properly completed application form attached,

iii other accompanying documents including:

- list of shareholders in prescribed format,
- authenticated ownership certificate and/or lease agreement for building, land, vault, equipment and fixture,

- feasibility study of the future operations and development of the business for minimum period of three years from the date of commencement of operations,
- description of actual purchases made or proposed purchases of goods and services, or lease of real estate by the bank from related parties,
- proposed memorandum & articles of association,
- name and nationality of influential shareholders, and number and value of shares they hold;

= name, age and marital status of directors, CEO and SEOs and evidence confirming that they meet qualification of competency,
= list of names, nationality, number and value of shares held by those who hold capital of Br.100,000 or more,
=evidence for estimated insurance cover for fixed assets acquired or leased,
= "propriety" questionnaire completed by directors, CEO and SEOs to assess whether they have honesty, integrity, diligence and good reputation,
= "propriety" questionnaire completed by influential shareholders,
= evidence for payment of investigation fee of birr 750,
= evidence for payment of minimum paid-up capital of birr 500 million in cash,
= evidence for valuation of contribution in kind, where applicable,
= tax ID number of the licensed bank,
= confirmation in writing that no shares are bought using bank loans,
= evidence in writing confirming that the board elects are not serving as director or CEO in any other financial institution,
= confirmation in writing that influential shareholders have no shares in any other bank;
= renewed business license, if shareholders are businesses, and
= evidence for payment of licensing fee of birr 5,550.
- Publishing on newspaper a notice of intention to engage in a banking business in prescribed form at least once a week for a period of four consecutive weeks,
- premises, security arrangements and cash vault meeting minimum standards,
- full payment of 1/4th of subscribed shares, and
- ensuring that shareholding is limited to 5 percent of total subscriptions.
c) For more information, see NBE website http:/www.nbe.gov.et, banking business proc. 592/08 & NBE directives SBB/39/06).
d) Contact address:
-policy and licensing team,
-telephone (office): 011 517 51 78.
e)Standard time for decision:
-within 90 days of receipt of complete application.

2.2 **Approval to Commence Operation**
a)Conditions required:
- written application to commence operation,
- comprehensive risk management policies and operating manuals put in place,
- adequate and appropriate staff hired, trained and placed,
- suitable banking hall and staff operating areas,
- a strong room with a minimum carrying capacity of 224 cubic meters,
- cash loading and unloading area suitable and protected from public view and access,
- fire extinguishers placed at appropriate places,
- insurance policy purchased at least for fire and other perils, burglary and theft, fidelity, cash and valuables in premises and in transit,
- outer doors of the bank building being of heavy duty metal,

- all windows and glass walls of the bank building reinforced with metal grills and
- sound information management and internal control systems.
b) For more information, see NBE website http:/www.nbe.gov.et and directives SBB/39/06.
c) Contact address:
- supervision teams,
- telephone (office): 011 517 51 38/53 36.
d) Standard execution time:
- within 10 working days.

2.3 **Renewal of License**
a) Conditions required from customers to get renewal of license:
- written application, from July 1 to September 30 only, for renewal of license,
- completed form depicting balances of subscribed and paid up capital as at end of June,
- tax ID number of the bank,
- a copy of evidence for payment of license renewal fee of birr 5,550 and
- enclosure of original banking business license.
b) For more information, see NBE website http:/www.nbe.gov.et, directives SBB/39/06, & circular BSD/03/11).
c) Contact address:
- policy and licensing team,
- telephone (office): 011 517 51 78.
d) Standard execution time:
- within 1 hour of receipt of complete application.

2.4 **Approval of Branch License**
a) Conditions required:
- written application for approval with completed form and
- evidence for payment of investigation fee of birr 500.
b) For more information, see NBE website http:/www.nbe.gov.et and directives SBB/40/06.
c) Contact address:
- policy and licensing team,
- telephone (office): 011 517 51 78.
d) Standard execution time:
- within 1 hour of receipt of complete application.

2.5 **Approval of Branch Opening**
a) Conditions required:
- written application for approval with completed form 15 days before commencement of operation (applies to relocated branches as well).
- Minimum requirements including (applies to relocated branches as well):
+ bank's relevant policies and procedures and NBE directives and circulars distributed to appropriate staff of the branch,
+ branch adequately guarded,
+ working hours, copy of the bank's license and branch authorization displayed in a visible area of the branch,
+ banking hall and staff operating area suitable for the type of business to be undertaken in the premises housing the branch,
+ appropriate strong room or safe/vault,
+ fire extinguishers placed in appropriate area,

+ insurance policy at least for fire and other perils, burglary and theft, fidelity, cash and valuables in premises and transit;
+ outer doors of branch building of heavy duty metal, &
+ windows and glass walls of branch building reinforced with metal grills.
b) For more information, see NBE website http:/www.nbe.gov.et, directives SBB/40/06, & circular BSD/01/11.
c) Contact address:
- policy and licensing team,
- telephone (office): 011 517 51 78.
d) Standard execution time:
- within 2 hours of receipt of complete application.

2.6 **Approval of Branch Relocation**
a) Conditions required:
- written application for approval along with completed form,
- a copy of evidence for payment of investigation fee of birr 500 and
- attached original branch authorization.
b) For more information, see NBE website http:/www.nbe.gov.et and circular BSD/02/11.
c) Contact address:
- policy and licensing team,
- telephone (office): 011 517 51 78.
d) Standard execution time:
- within 3 working days of receipt of complete application.

2.7 **Reopening of a Closed Current Account**
a) Conditions required:
-written application for reopening of the account, with a copy to the Federal Police Commission, with a commitment to properly use the account in the future,
- suspension for a minimum of 18 months from use of current account, or a guarantee valid for the period from a domestic bank and
-enclosing evidence for full settlement of all dishonoured checks & related penalty charges.
b) For more information, see NBE website http:/www.nbe.gov.et and directives SBB/31/02.
c) Contact address:
-policy and licensing team,
-telephone (office): 011 517 51 78.
d) Standard execution time:
- within 2 working days of receipt of complete application.

2.8 **Approval of External Auditor**
a)Conditions required:
-written application for approval of appointed external auditor and
-additional information to be submitted (for approval of original appointment only):
+ registered name of the auditor,
+ name, qualification and experience of each partner,
+ address (location, P.O. Box, telephone no.),
+ name, qualifications and experience of the manager to be engaged in the audit of the bank,
+ details of the auditor's experience in auditing other banking or similar institutions,
+ details of any existing business relationship between the auditor or his partners and the bank,
+ copy of the license to practice auditing, including for each partner in the case of firm,

+ copy of minutes of the general meeting of shareholders approving the appointment of the auditor, and
+ any other information considered necessary in support of the application.
b) For more information, see NBE website http:/www.nbe.gov.et and directives SBB/19/96.
c) Contact address:
- policy and licensing team,
- telephone (office): 011 517 51 78.
d) Standard execution time:
- within 1 working day of receipt of complete application.

2.9 **Approval of Minutes of Annual General Meeting (AGM) and/or Amended** Memorandum and Articles of Association (M&AoA)
a) Conditions required:
- written application for approval of minutes of AGM and/or amended M&AoA,
- minutes of AGM and/or amended M&AoA and
- attendance sheet.
b) For more information, see NBE website http:/www.nbe.gov.et, banking business proc. 592/08 & NBE directives SBB/39/06.
c) Contact address:
- policy and licensing team,
- telephone (office): 011 517 51 78.
d) Standard execution time:
- within 5 working days of receipt of complete application.

2.10 **Approval of Influential Shareholding and/or, Appointment of Replaced Directors, CEO and/or SEOs**
a) Conditions required:
- written application for approval of influential shareholding and/or appointments for replacement,
- board minutes evidencing deliberations on all relevant issues,
- supporting documents like curriculum vitae, certified credentials, and working experience for directors, CEO, and SEOs,
- propriety test questionnaire completed, and last audited financial statements of businesses owned or managed (if any) by would be influential shareholders, directors, CEO and/or SEOs,
- number and value of shares held by would be influential shareholders, and written statements declaring source of their funds and they have no shares in other banks; and
- written statements evidencing proposed directors are not board members in any financial institution operating in Ethiopia.
b) For more information, see NBE website http:/www.nbe.gov.et and directives SBB/39/06.
c) Contact address:
- policy and licensing team,
- telephone (office): 011 517 51 78.
d) Standard execution time: within 30 working days of receipt of complete application.
2.11 **Approval of New Banking Product**
a) Conditions required:
- written application for approval of new products,
- submission of full set of study documents including:
+ target market,
+ related risks,
+ risk management process, internal control, MIS, organization, staffing, training, and

+ policies and procedures; and power point presentation, about the new products, to the NBE.

Monetary Policy Framework of National Bank of Ethiopia

I. **Introduction**

Monetary policy of central banks in a simplified analysis amounts to the determination of the "optimal" quantity of money or (in a dynamic sense) the optimal rate of growth of the money stock. But there is more to monetary policy than the determination of the optimal stock or growth rate of money. More generally, monetary policy refers to a bundle of actions and regulatory stances taken by the central bank including all of the following:

- Setting minimum interest rates on deposits or the rediscount rate charged to Commercial banks' borrowing reserves,
- Setting reserve requirements on various classes of deposits,
- Increasing or decreasing commercial bank reserves through open market purchases or sales of government securities,
- Regulatory actions to constrain commercial bank financial activity or to set minimum capital requirements,
- Intervention in foreign exchange markets to buy and sell domestic currency for foreign Exchange,
- Decide on level of required reserve of commercial banks total deposit. It is self-evident that monetary policy plays an important role in the performance of an economy. However, the effectiveness of the policy in achieving the intended goal largely depends on the institutional factors that constrain or facilitate the implementation process of the policy. In what follows the monetary policy framework of the National Bank of Ethiopia will be described detailing the monetary policy objectives, the targeting framework, the instruments of monetary policy and legal & institutional framework of the monetary policy decision-making structure as well as the exchange rate regime of the country.

2. **Monetary Policy Objective**

The principal objective of the monetary policy of the National Bank of Ethiopia is to maintain price & exchange rate stability and support sustainable economic growth of Ethiopia. Price stability is a proxy for macroeconomic stability which is vital in private sector economic decision on investment, consumption, international trade and saving. Finally, macroeconomic stability fosters employment and economic growth. Maintaining exchange rate stability on the other hand is considered as the principal policy objective of NBE so as to be competitive in the international trade and to use exchange rate intervention as policy tools for monetary policy to affect both foreign reserve position and domestic money supply.

More specifically, the objectives of Ethiopia's monetary policy are to:

i Foster monetary, credit and financial conditions conducive to orderly, balanced and sustained economic growth and development.

ii Preserve the purchasing power of the national currency – ensuring that the level of money supply is generally consistent with developments in the macro- economy and intervening in the foreign exchange rate market for the purpose of stabilizing the rate when conditions necessitate.

iii Encourage the mobilization of domestic and foreign savings and their efficient allocation for productive economic activities through the implementation of a prudent market-driven interest rate policy.

iv Facilitate the emergence of financial and capital markets that are capable of responding to the needs of the economy through appropriate policy measures. These measures would ensure the gradual introduction of trading instruments on a short-term basis.

3. Monetary Policy Strategy/Targeting Framework

Monetary policy strategy of a central bank depends on a number of factors that are unique and contextual to the country. Given the policy objective, any good strategy depends on the macroeconomic and the institutional structure of the economy. An important factor in this context is the degree of openness of the economy. The more open the economy is, the more the external sector plays a dominant role in monetary management. Within a country's monetary management framework, there are basically three targets: the ultimate or final target, the intermediate target and the operating target.

3.1 Final and Intermediate targets

The final targets of monetary policy in Ethiopia are to maintain price and exchange rate stability and support sustainable economic growth. In achieving these objectives, the NBE sets money supply as an intermediate target. It should be noted that intermediate targets are not directly controlled by the central bank.

Traditionally, money supply is defined from its narrow and broader sense. Narrow money (M1) is a measure of money stock intended primarily for use in transactions. It consists of currency held by the public, traveller's checks, demand deposits and other checkable deposits. Broad Money (M2) is a measure of the domestic money supply that includes M1 plus Quasi-money (savings and time deposits), overnight repurchase agreements, and personal balances in money market accounts. Basically, M2 includes money that can be used for spending (M1) plus items that can be quickly converted to M1. NBE takes the broader definition of money or M2 as money supply. The current target is to ensure that the money supply growth is in line with nominal GDP growth rate.

3.2 Operational target

The operational target is an economic variable that the central bank wants to influence, largely on a day-to-day basis, through its monetary policy instruments. They can be used to link instruments of monetary policy to intermediate targets set by the central bank and represent the first impulse in the transmission process of monetary policy. The growth of base money/reserve money is being used as operational target of the National Bank of Ethiopia. Reserve money (Base money) is defined as the sum of currency in circulation and deposits of commercial banks. The practice of targeting reserve money is based on the assumption that there will be a stable money demand function in the economy. If the money demand happens to be unstable over the medium to long term, then the NBE will shift its targeting in to another workable framework such as interest rate targeting or multiple indicator approach. In addition, the Bank shall maintain the international reserves at a level which, in its opinion, is adequate for Ethiopia's international transactions. In this regard, a minimum threshold at which foreign reserves are considered adequate is set at three months of imports of goods and services.

4. Monetary Policy Instruments

The introduction of a wide range of monetary instruments by central banks engenders competition, efficiency and transparency and broadens financial intermediation in the banking system. It also promotes liquidity management of commercial banks and gradually leads to the development of well functioning money and financial markets which could serve as catalysts for economic growth and development. So far, the use of such instruments has been extremely limited in Ethiopia due to the underdevelopment of the money market and the virtual non-existence of a financial market. Thus, it is envisaged to use a mix of diversified monetary policy instruments so as to effectively carry out the monetary management function of the NBE. **Open Market Operation (Sale & purchase of bonds or securities issued by governments)** has generally been used by countries as one of the main instruments for the development of money markets. Trading in these instruments liquefies the financial system in particular and the national economy in general and increases financial intermediation among market participants. In light of this, the NBE will use open market operations (sale and purchase of government securities) as one of its monetary policy instruments. In the absence of its own securities, certain amount of government treasury bills needs to be allocated to NBE by the government for its monetary policy purpose. To prepare the ground for enhanced open market operations, the yield on government securities should be at least close to the minimum interest rate. As a next step, secondary market for government securities needs to be established. A standing central bank credit facility is another instrument used to enhance the financial capacity of commercial banks and to promote financial intermediation and efficiency. The key advantages of such standing credit facility are transparency and predictability of accessing central banks' resources to cover short-term needs. This credit facility gives banks an assurance that, when confronted with problems of shortfall in the clearing and a lack of alternatives for raising immediate funds in the inter-bank market, they can settle the clearing with the central bank's funds at a reasonable interest rate which has a clear relationship with short term market interest rates. The NBE will use this facility as one of its monetary policy instrument.

Other monetary policy instruments used and to be used include:

- Reserve requirement,
- Setting of floor deposit interest rate (until interest rate is fully deregulated)
- Direct borrowing/lending in the inter-bank money market and introducing re-purchase agreement (repo/reverse repo operations),
- Use of selected credit control when necessary, and
- Moral Suasion.

5. Legal and Institutional Framework

5.1 Board of Directors

According to NBE Establishment proclamation No. 591/2008 (as amended), a Board of Directors composed of seven members governs the National Bank of Ethiopia. The Governor and Vice Governor of the Bank are permanent ex-officio members while the Chairperson of the Board of Directors as well as the remaining four members are to be appointed by the Government. The Board of Directors plays a role in monetary policy formulation, as it is the highest decision making body of the Bank. To this end, the Monetary Policy Committee shall submit regular information & policy proposals to the Board regarding developments in the monetary sector, exchange rate, price, interest rate and financial sectors as well as the reasons for the proposed stance of monetary policy. The Board of Directors will meet regularly at least once every three months and is required within short intervals to discuss and decide on monetary policy stance. The monetary policy stance will be published as Monetary Policy Statement in hard copy and posted on NBE's website as per the pre-announced calendar. A press statement will also be given on the date of issuance of monetary policy statement.

5.2 Monetary Policy Committee

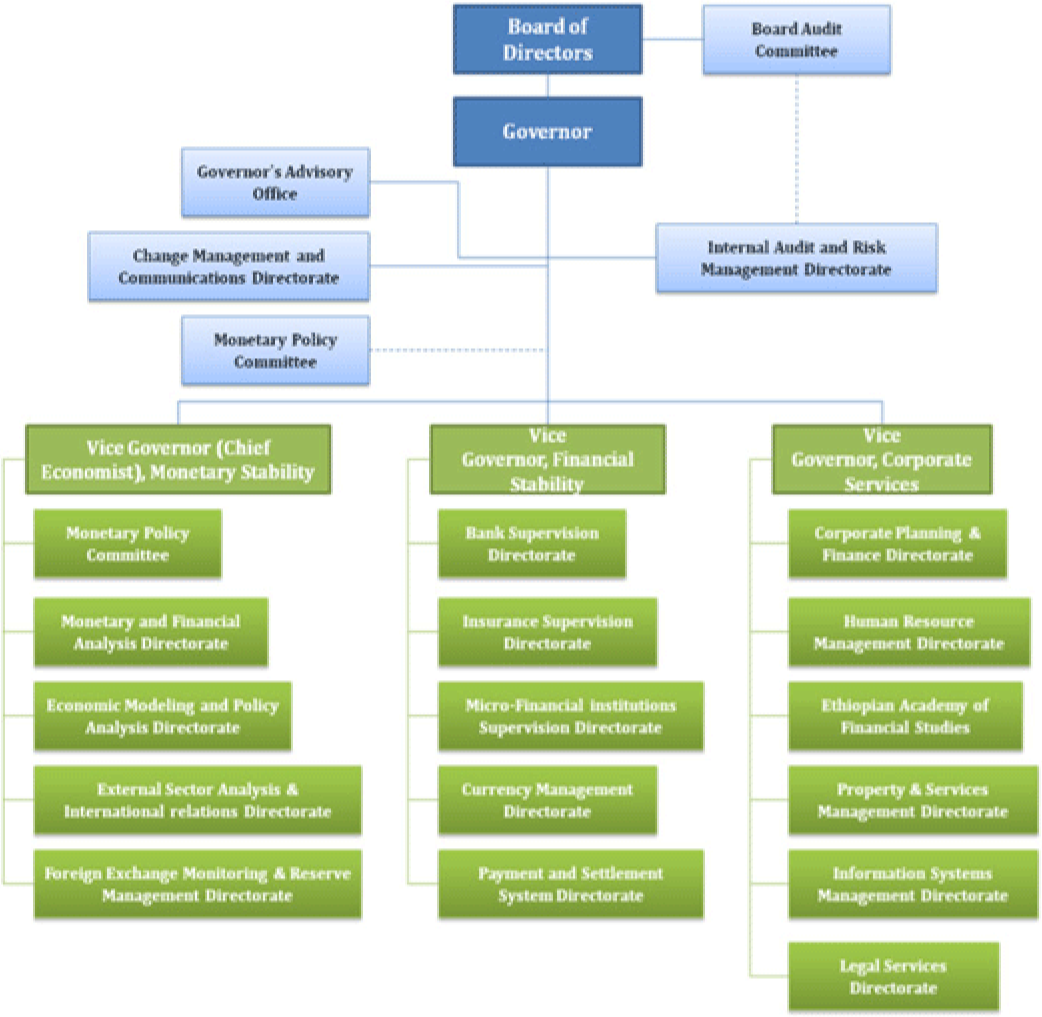
The Monetary Policy Committee (MPC) of the National Bank of Ethiopia is responsible for the periodic review of monetary policy, exchange rate, price, interest rate and financial sector developments of the country and propose monetary policy stance to the Bank's Board of Directors on regular basis as per a pre-announced calendar. The MPC will be chaired by the Governor of the Bank, and will have the following members:

- Chief Economist and Vice Governor of Monetary Stability (member and vice chairman);
- Vice Governor of Financial Stability (member);
- Vice Governor of Corporate Services (member),
- Senior Advisor to the Governor (member);
- Director of Foreign Exchange Monitoring and Reserve Management Directorate (member)
- Director of Monetary & Financial Analysis Directorate (member);
- Director of Bank Supervision (member); and

• Director of Economic Modelling and Policy Analysis Directorate (member and secretary).
The Governor may assign additional members to the MPC on the basis of their expertise in the area of monetary policy as the case may be.

The MPC meets quarterly based on a pre-announced calendar to deliberate on monetary policy matters. The Governor may also call for extraordinary MPC meetings at his/her discretion to discuss emerging domestic and global economic challenges. At each meeting, the committee shall take decisions on the appropriate stance of monetary policy for the next three months. The decision will be based on consensus unless it is absolutely necessary to take majority votes. If there is a tie, then the Governor shall have a final say. During an MPC meeting, the Chief Economist makes presentations to the MPC on recent economic developments in the world and domestic economies, and on the inflation outlook. The MPC may also invite other professional staffs of the Bank to make additional presentations on selected issues. In terms of domestic economic developments, indicators such as the performance of the real sector, interest and exchange rate developments, the balance of payments, monetary aggregates, financial sector issues and fiscal trends will be taken into account. As a routine activity of the Bank, all major economic and financial indicators will be monitored and the MPC briefed on these issues every quarter. These indicators include liquidity of the banking system, inflation and exchange rate trends, financial market developments, foreign exchange reserve position, real sector indicators, balance of payments, and fiscal trends. In addition, the Bank makes use of monthly and quarterly internal inflation forecasts. Forecasts will be based on price developments in selected commodities, using econometric methods. From time to time, the MPC may also request additional presentations relating to monetary policy, financial stability and reserve management issues by other invited staff of the Bank. However, only the views of MPC members shall be taken into consideration when making decisions on the stance of monetary policy. All decisions relating to monetary policy matters are taken by consensus. Where consensus does not emerge, the Chairperson will have the final say. Each member also needs to state his/her decision clearly, along with the reasons for taking such decision.

Organizational Structure of the National Bank of Ethiopia



Banking Reform in Ethiopia

The monopoly government-owned banks in Ethiopia remained relatively sound throughout the period of socialist government. This was because: the parastatal sector, to which the banking sector was forced to lend, remained profitable; and, branch expansion was steady rather than reckless. Partly as a result of this, there was considerable financial deepening, helped by real interest rates not being continuously negative and by public confidence in the banking system not being threatened.

Financial sector reform in the 1990s included government development banks becoming commercial banks, and the licensing of new private sector banks. However, the ability of the reformed banking system to service the rapidly growing private sector was limited because:

i the government-owned banks appeared unlikely to compete with each other,

ii foreign participation in banking was forbidden, without which neither the old government nor the new private sector banks seemed likely to have sufficient commercial lending expertise.

New indigenous commercial banks were licensed, but the new banking laws were inadequate and the central bank had very limited bank supervision capacity, so that this was a high risk policy.

The practice of banking changed fundamentally, however. The banks' large customers became public enterprises, and the banks were instructed to lend to them in support of the government's development plans. The banks were not able to refuse to implement these instructions on the basis of commercial lending criteria. Given the consequences of similar policies elsewhere in Africa, most of the Ethiopian banks survived the socialist period in better condition than might have been expected. Moreover, money supply grew steadily in real terms and as a proportion of GDP, which was also a contrast to what happened in several countries where government-owned banks dominated.

1 **Impact on financial institutions: the Commercial Bank of Ethiopia (CBE)**

During the socialist period, the CBE and the other government banks were obliged to lend to public enterprises according to government instructions, which were based in turn on central planning. The CBE could not refuse credit in these circumstances, regardless of whether its credit assessment was positive or negative. Elsewhere in Africa, similar policies have led to the large-scale accumulation of bad debts, extensive fraud and insolvency.

The CBE was an exception to this generalisation. There were a number of reasons. **First, and probably most fundamentally**, during most of the socialist period, the majority of public enterprises made a profit and were therefore able to service their debts (Chole,1994). To a considerable extent, the ability of public enterprises to service their loans was assured by their receiving sufficient allocations of scarce foreign exchange to remain viable. The profitability of public enterprises was sharply reduced during the civil war. From 1989, they suffered from reduced capacity utilisation because of worsened foreign exchange shortages, losses were made and they did not pay debt service. However, this problem lasted for only one or two years. Public enterprises then returned to profitability because foreign exchange became more readily available. Lending to the private sector (varying between 30 and 40% of loans and advances between 1981 and 1993) was equally straightforward: without foreign exchange, potential borrowers were not creditworthy, with foreign exchange allocations they were virtually guaranteed to be profitable.

In practice, the CBE clearly expected the government to carry any un-recovered losses eventually. The losses incurred from lending to the construction sector have been "presented" to government; and, government is expected to issue bonds in their place. There was therefore a second line of defence in the CBE's lending to parastatals, namely that the bank is expected to be compensated for the cost of any bad debts resulting from lending it had been instructed to do. There are examples of banks continuing to lend on the basis of government guarantees which clearly could not be honoured, and which both parties knew could not be honoured (White, 1993), but Ethiopia does not appear to have been in this situation. There is a certain logic in such procedures, in that the banks, all government-owned, were part of the public sector. As a consequence, the allocation of expenses, such as parastatal inability to pay debt service, was to some extent a matter of accounting procedures. Bank deposits were considered as an additional resource to finance public sector activities, with the possibility of later repayment; the government-owned commercial bank was simply a convenient transmission mechanism, rather than a source of independent decision-making on the allocation of resources. In such a situation, it was not in the government’s interest to undermine the functioning of the bank if the "borrowers" were unable to repay. Most unusually in these circumstances, the CBE continued to do credit analysis of lending decisions according to the commercial criteria used in the pre-socialist period, and continued to train its staff in the necessary techniques, even though the majority of lending was to public enterprises and the bank was not able to refuse government instructions to lend where that analysis was negative. The management of commercial banking was therefore apparently a rather unusual mixture of continued attention to commercial criteria, combined with submission to the demands of central planning in making loans to public enterprises. This had important consequences. Some technical capacity to make loans using commercial criteria was retained, enhanced by the continuity of employment in the management cadre of those with pre-1975 experience.

A **second** factor was that although the CBE was under pressure from the government to expand its branch network, the expansion which took place was not so rapid, apparently, as to endanger the efficiency and therefore the profitability of the bank. Source: Commercial Bank of Ethiopia Statistical Review, June 1994

Third, the spread between deposit and lending rates, as determined by the central bank, remained adequate to give CBE comfortable profits. An important factor in banking margins was that non-interest bearing demand deposits were always between 50 and 60% of total deposits, and the cost of servicing demand deposits was held down by the CBE not opening accounts for individuals. Put slightly differently, the profitability of CBE was underwritten by the large demand deposits of public enterprises and the central government, which together accounted for approximately 50% of all CBE’s demand deposits. The only exception to comfortable profits was in the early 1990s, when a change in interest rates sharply reduced gross lending margins; apart from this short period, the return on assets never fell much below 2%, and the return on capital only fell below 100% in 1991.

Fourth, it would have been possible for bad debts to have rendered CBE insolvent, whatever the spreads available. On the published evidence, this did not happen. The bank always provisioned for doubtful debts, with the ratio of annual provisions to loans outstanding varying between 0.9% and 2.8%. This degree of variation suggests that something better than a mechanical formula was being applied. Cumulative provisions were much larger, varying between 14 and 27% of total lending, because bad debts actually written off were always a very small proportion of provisions: 10% from 1981 to 1983, and from 1 to 5% thereafter. Either the writing off of bad debts was inadequate, or unnecessary provisions amounted to a hidden reserve. In 1994, reserves were B224 million compared with cumulative provisions of B467 million. Writing back most of the cumulative total of provisions into capital, under the assumption that actual bad debts really are indeed less than five per cent of provisions, would more than triple the bank’s reserves.

Provisions for doubtful debts are to some extent a consequence of auditing standards. The CBE's accounts were audited by a government agency, the Audit Services Corporation. This agency claims in the CBE annual reports to use generally accepted auditing standards, and to have arrived at the provision for doubtful debts "after reviewing each account". The agency has on occasion demonstrated its independence by noting publicly that bad debt provisions of another government bank were inadequate. Audit standards were also given international approval, although this was some years ago (World Bank, 1982).

Fifth, it should be noted that the risk of lending to parastatals was somewhat reduced because deposits of public enterprises were very roughly as large as, and frequently larger than, loans outstanding. Collectively, therefore, public enterprises did not threaten the solvency of the CBE.

Sixth, CBE substantially reduced its risk exposure during the socialist period. Whereas lending was 39% of total assets in 1981, this percentage was fairly steadily reduced, falling as low as 16% by 1991 and 1992. If customers' liability for Letters of Credit is combined with lending, then the risk exposure of the bank fell from 55% to only 22% over the same period. Instead, the bank held increasing amounts of cash (including balances with the central bank and foreign banks), Treasury Bills and government bonds: together these rose from 38% of total assets in 1981 to an average of 76% in 1991 and 1992.

Seventh, there was apparently no pressure on CBE to employ under-qualified political appointees. Although lack of evidence on this point is necessarily inconclusive, it is nevertheless striking in contrast to plentiful reports of this problem in government-owned commercial banks in, for example, Ghana, Tanzania and Uganda (Ashenafi, 2012).

As a consequence of these factors, the ratio of CBE's capital and reserves to loans outstanding remained comfortably above 9%, averaging 10.7% in the period 1981-92. The ratio of capital and reserves to all risk assets (loans plus liabilities on Letters of Credit) was slightly lower, averaging 7.3%. These ratios were respectable, even though they were relatively unnecessary given that most lending was to state-owned enterprises with their implicit guarantees and matching demand deposits. Capital ratios remained adequate despite reserves being constant in nominal terms from 1983 right through until 1992. This was because lending was also stagnant in nominal terms, remaining (after some upward fluctuations) below its 1981 level until 1992. It did not matter, therefore, that the bank was not permitted to retain any of its profit for addition to reserves. It paid half its profits in tax, and the other half as a dividend to the government (CBE, 2010).

When lending increased in 1993, by more than 100%, the capital adequacy ratio fell to 3%; in 1994, reserves were more than doubled, raising the capital ratio to 5.6% (CBE, 2011).This partial restoration of capital adequacy was made possible by allowing the bank to retain some of its post-tax profits. The return of property nationalised after the fall of the imperial government also added to the bank's capital. The institutional soundness of the CBE was sustained, therefore, by a steady reduction in the proportion of loans and advances in its assets, by the high proportion of loans to (solvent) public enterprises which also carried an implicit government guarantee, by apparently adequate provisions for bad debts, by the maintenance of reasonable (if not generous) capital ratios, and by its remaining profitable. Although profits were all paid to the government, there was the potential for their being used to augment capital reserves, as was done in 1994. This comfortable position could of course be undermined by changing circumstances, for example if public enterprises were to become unprofitable as a result of economic liberalisation and were to have government guarantees of their debts withdrawn, or if the shift to lending more to the private sector were to result in sharply increased bad debts. Moreover, it is not possible to be absolutely certain that bad debts were not being concealed while bank supervision was weak and audit was by another government institution.

2. Impact on financial institutions: the AIDB and the HSB

To a limited extent, the existence of other government-owned financial institutions protected the Commercial Bank of Ethiopia from government pressure to lend in ways that would have created large-scale bad debts. The Agricultural and Industrial Development Bank (AIDB) was obliged to provide both short and long term finance to state farms. As a result, CBE did not have to do this and thereby escaped the almost total inability of the state farms to service their debts. They were loss-making, despite being paid higher prices for their output than other farms. Their financial problems were made worse by being set up with 100% loan capital, but even the provision of equity finance would not have been enough to make them viable.

The third government-owned bank, the Housing and Savings Bank (HSB), concentrated on an area of lending to which the CBE was also not under any pressure to lend, namely the purchase and construction of buildings. Although the HSB was not profitable, its losses were modest. It is unlikely that the CBE would have been endangered if it had been obliged to cover this area of lending.

3. **Interest rate policy and the real growth of bank deposits.**

During the socialist period, the government appears to have been supremely unconcerned about interest rates. The nominal deposit rate was almost unchanged from 1981 until 1989 (there are no official records of interest rates prior to 1985 other than the Treasury Bill rate, which was 2.80% in 1981 and unchanged at 3% from 1981 to 1991). Significantly, annual reports of the central bank and CBE contain a wide range of statistical tables, but there is no table of interest rates in either publication, and in year after year there is no mention of interest rates in their text. During most of the period since 1981, therefore, the main determinant of the real deposit rate was the rate of inflation; the range of real deposit rates was from -36% to +16%. The response of depositors, as measured by changes in the real value of interest-bearing deposits, followed changes in the real deposit rate quite closely, as can be seen in (IFS, 2004).

4. **Impact of financial liberalisation on banks: Agricultural and Industrial Development Bank (AIDB).**

The AIDB also became a commercial bank in 1994. At the same time, it changed its name to the Development Bank of Ethiopia (DBE, which had been its name in one of its previous incarnations). Like the HSB/CBB, its initial condition and preparations for becoming a commercial bank appeared likely to be inadequate for it to attract deposits other than from the public sector, or for it to provide significant competition for the other government banks.

After the change of government in 1975, the proportion of AIDB's lending to agriculture increased from 48 to 80% by 1981, mainly for the start-up and operation of state farms. The resources for this lending came from the central bank. In 1992, the bank was insolvent, with an accumulated deficit of B186 million considerably greater than capital of B100 million, even though it had not been acknowledged at that stage that lending to state farms would have to be written off. The auditors' report was heavily qualified. There was a major capital restructuring in 1994. Loans to state farms were written off. Some medium and long term loans from the government and the central bank were converted into equity; some central bank loans were cancelled; and a smaller amount (B250 million) was partially replaced by government bonds to be made available over five years. The net result was to reduce the balance sheet from approximately B2.5 billion to B1 billion. This was stated to be enough for the bank to meet capital adequacy ratios.

In the past, the bank derived very few resources from deposits (less than 6% of liabilities in 1992), all of which were from other public sector institutions. This suggests that the bank would find it difficult to attract deposits on a sufficient scale to finance future lending, unless it continued to get deposits from public sector institutions under government instructions and government guarantee. Moreover, in 1994 it became illegal for the central bank to continue lending to the AIDB/NBE, having previously been the largest provider of resources. The Monetary and Banking Proclamation (83/94) excludes any NBE lending other than to the government.

Initially, the plan was for AIDB/DBE to accept deposits only from borrowers. This would add only a limited amount to deposits, so that the bank would remain dependent on the public sector for most of its resources. Management used the same rather optimistic argument as the Commercial Bank of Ethiopia, that sufficient expertise remained, from before the socialist period, for the sound management of a rapid increase in lending to the private sector using commercial criteria. Meanwhile, like the other government banks, DBE's formal board of directors remained the high level group of cabinet ministers, chaired by the Central Bank Governor, which meets very seldom. In practice, this meant that lending decisions were made by the management, although loans greater than B2 million had to be approved by the Governor. This arrangement seemed inappropriate for a more commercial attitude; central bankers have neither the training nor the experience for making commercial lending decisions. It had been decided that the DBE would have its own board of directors, but it had not been appointed at the time of it becoming a commercial bank, nor were plans for its establishment being actively considered by the Prime Minister's Office.

Management believed that the DBE would be able to compete with other banks, although probably not for the first two or three years. However, it also planned to learn from the Commercial Bank of Ethiopia with which it is expected to cooperate. This was a further example of the probable lack of competition between government banks. Competition with other government banks was particularly unlikely for DBE while it continued to be so dependent on deposits and loans from official sources.

5. Impact of financial liberalisation on banks: indigenous commercial banks.

Financial sector reforms in Ethiopia do not allow private sector participation in existing government banks, nor do they allow the entry of foreign banks. Somewhat unexpectedly, however, new locally owned commercial banks can be licensed. The first began operating in 1995. By mid-1996, two further local banks had been licensed, with rumours that further applications were likely.

Although the new banks are bound to be small in relation to the existing large government banks for some years, their development potential is potentially much greater than their initial size. Whereas the existing banks are very unlikely to compete with each other significantly, the new indigenous banks have to compete vigorously for both deposits and creditworthy borrowers. This provides Ethiopia's best chance of improvement in the quality of bank services, the creation of new financial services, and lower costs. A second potential advantage, from the point of view of the national economy, is that the indigenous banks have to seek borrowers from among small and medium scale businesses. This is because prudential lending rules (setting limits to the proportion of capital that could be lent to any one borrower) should exclude them from lending to large corporations. However, this is unlikely to appear as an advantage to the new banks.

It seemed likely that the new banks would find it easy to attract deposits, and this proved to be the case. The existing banks, in particular the Commercial Bank of Ethiopia as the only commercial bank in the past, were very slow, bureaucratic and user unfriendly. Given the monopoly position of the Commercial Bank of Ethiopia, this was not surprising. Moreover, individuals were not generally allowed to open current (checking) accounts. This created an opportunity for new banks to compete successfully for deposits, by offering a better service. Moreover, they did not have to use political connections to attract deposits. This reduced their need to try and use political connections to attract deposits, and therefore protected them from the subsequent withdrawal of deposits for political reasons, a factor which contributed to the downfall of some indigenous banks in Kenya and Zambia, for example. The new indigenous banks were handicapped initially by there being no way of investing liquid assets so as to earn interest. The National Bank of Ethiopia would not pay interest on deposits, there was no market in Treasury Bills at all, and the Commercial Bank of Ethiopia refused to allow the deposit of shareholders' money in interest-bearing savings accounts. New banks were therefore unable to earn any income on the capital subscribed before they began operations. This situation forced new banks to pay all initial expenses out of capital. However, a Treasury Bill auction was initiated in January 1995, before any of the new banks began operations.

Nevertheless, new banks were under considerable pressure to build up their lending as fast as possible, because of the large gap between the low return on Treasury Bills (3%) and the controlled rates of interest on lending (currently between 11 and 16%). There was therefore a risk that the new banks would take insufficient care over initial applications for credit. Lending decisions were in any case likely to be more difficult for new indigenous banks. Small and medium scale businesses have relatively high administrative costs per amount lent. They also have less reliable accounting information, while new banks face the additional problems of developing information about loan applicants from scratch. This problem is faced by all lenders to small and medium sized businesses, but established banks can carry the risk very much more easily, losing the protective cushion of profits from lending to larger businesses and long established borrowers. The new Ethiopian banks were further handicapped by not being able to draw on the foreign assistance that might have been available if foreign partners had been allowed.

Despite finding it easy to attract deposits, helped by the opening of seven branches in its first year, the first of the new banks reported that it was unable to meet the demand for credit. It apparently had no difficulty, therefore, in finding what it regarded as creditworthy borrowers. It is possible that there really was a significant number of sound lending opportunities among businesses previously excluded from access to credit from the government banks. The latter were profitable without having to seek out new borrowers, and were under no political pressure to do so. Even if there was a profitable lending gap, the rate of expansion of lending, and of branches (several additional branches were planned), was worrying; it was too soon, however, for the quality of lending to be known.

A further problem was that new banks were licensed under an inadequate new banking law, and before the establishment of adequate supervisory capacity.

6. **Banking legislation and supervision.**
The new banking law (Proclamation No. 84/1994) was passed in January 1994. This established the minimum capital requirement for establishing a commercial bank (B10 million, US$1.7 million at end-1994) and capital adequacy ratio (8% of risk weighted assets).

Any applicant complying with the proclamation's provisions may be granted a licence. The proclamation says nothing about the central bank having any right to approve of the applicant's directors and senior management, other than that their names, occupations and addresses should be supplied, and that anyone associated with a previous bank failure requires specific permission to be involved with a new bank. This seemed to reduce the central bank's discretion to prevent the establishment of banks by people with inadequate experience or with inappropriate motives.

There were other worrying features of the legislation:
First, the Proclamation does not specify any maximum percentage of capital and reserves which may be lent to any one borrower. It was expected that the figure would be 10%, as it had been previously (but by regulation not statute law) with central bank approval required for lending above this figure. However, it was also widely expected that this would be "negotiable", on the grounds that it would otherwise be too much of a constraint. Unexpectedly, the central bank itself was among those institutions which expected the 10% prudential rule to be applied flexibly. In 1996, discussion revolved around abandoning the requirement for central bank approval, while raising the 10% limit.

Second, there were no rules laid down about provision for doubtful debts other than that they should be to the satisfaction of the central bank. It would be unusual for such rules to be stated in the legislation. Nevertheless, failure to provide adequately for doubtful debts is a risk which it is particularly important to minimise in the case of new and small banks, especially where there is so little prior experience of supervising private sector banking. It would therefore have been prudent to establish the rules in legislation. Informally, the central bank required 25% of sub-standard loans to be provisioned against, with quite cautious definitions of sub-standard, but regulations had still not been agreed formally and published.

Third, all that the legislation says about insider lending is that limits on loans to directors and managers or directors' businesses "shall be determined by directives to be issued". There appeared to be sharply differing attitudes on this issue among the banks applying to be licensed. At one extreme, one new bank displayed a willingness to lend to directors' businesses, provided that the director concerned would not participate in such a lending decision. There appeared to be no awareness that this practice might be illegal, or that other directors would have an incentive to approve such loans in the expectation that they would be similarly treated by their colleagues. **This particular malpractice has been the single most common cause of indigenous bank failure in Africa**. At the other extreme, another new bank stated that it would make no loans at all to insiders.

Fourth, it was especially worrying, at a time when one indigenous bank had already been licensed and was about to start operations, that a head of bank supervision at the central bank had not been appointed in late 1994, while the deputy was abroad. This appeared to show a lack of awareness of the need for close supervision of new indigenous banks. The head of bank supervision was eventually appointed in 1995, and in 1996 had a staff of six. Because banking had previously been entirely doubling government-owned, and lending had been low risk, there was by definition little or no experience of supervising banks' management of the risks of commercial lending. Acquiring that experience while supervising new local banks, and government banks undertaking new types of business, could prove costly. **Yet there was again no resort to foreign technical assistance**. There were failures of indigenous banks in Nigeria as long ago as 1930, with subsequent repetitions, and in several other countries including Kenya, Zambia and Uganda in the 1980s and 1990s. Ethiopia might yet turn out to be different, but every possible means should be employed to make this outcome more likely.

Conclusion

Financial sector reform was a relatively minor part of the economic reforms undertaken before and after the fall of the previous government. Yet the banking sector was expected to support a major shift in the economy to private sector activity while undergoing considerable change. The two government development banks were transforming themselves into commercial banks, and for the first time since before 1975 private sector commercial banks were allowed to operate. There was, however, no intention of privatising the government banks, or of allowing any participation by foreign banks. The new private sector banks were obliged to be 100% Ethiopian-owned, even though at least one of them would have liked a foreign partner. This determination to develop the banking sector without foreign participation went further than the question of ownership. Transformation of the government banks, including the internal review of the Commercial Bank of Ethiopia, was being undertaken without foreign technical assistance. The new private sector banks were using virtually no foreign expertise; and, the new banking legislation showed few signs of external influence.

There was some willingness to try to employ the skills of Ethiopians working abroad, but the salaries available locally were generally not high enough to attract exiles with appropriate professional skills and experience. There is a general preference in Ethiopia for developing new policy using indigenous resources only, believing that long term development is enhanced by people learning from their own mistakes. In most aspects of development, this approach is clearly better than using foreign ideas and technology which is not based on an understanding of local conditions, and has not involved locals in its preparation and implementation. The failure of foreign investors, and of expatriates working in technical assistance programmes, to transfer their knowledge and experience has been powerfully criticised (Berg, 1993). In banking, however, the cost of mistakes in the form of bank failures can be very high, arguably higher than the benefits of learning by trial and error. The direct costs include the burden on the government budget of writing off bad debts and recapitalising government banks.

In addition, there is no guarantee that rehabilitated banks will remain solvent, so that both types of cost may recur at some later period. The indirect costs include slower development of the financial sector, and therefore reduced availability of credit, higher costs and slower development of new services. It becomes more difficult to enforce loan repayment when non-repayment has been permitted in the past; and, it becomes even more difficult if governments finance the writing off of bad debts. Sound indigenous banks lose deposits when unsound ones fail, and have to pay higher rates of interest in order to retain some deposits. These factors reduce the quantity and increase the cost of resources available for lending, especially to small and medium scale businesses (Harvey, 1995:145).

The history of banking in Ethiopia gives some support for arguing that these problems may be avoided. The government-owned banking sector was in a relatively sound financial condition during the early period of financial sector reform. There was nevertheless some risk that the shift to lending to the private sector, in an unfamiliar economic environment, while the two government development banks were also transforming themselves into commercial banks, would overstretch management capacity. The risks involved in too rapid rate of change were increased because the new banking legislation was inadequate on some important prudential issues, and because of the unprepared state of banking supervision. The latter was particularly worrying because new small indigenous banks were starting operations. The risk was increased in Ethiopia by exceptional pressure on the indigenous banks to increase their lending rapidly, because the rate of return on bank lending was so much higher than on the only available liquid assets, Treasury Bills.

It would be very damaging if one or more of the indigenous banks were to fail. This would make success more difficult for survivors, and for new banks trying to become established in the future.

The success of financial sector reform depended on which factor would dominate. On the one hand, quite fundamental changes were being implemented with what appeared to be inadequate use of foreign expertise and a lack of awareness of the problems which similar reforms generated elsewhere. On the other hand, the inherently cautious approach of the existing management in government banks, and of the government authorities, may succeed in preventing those problems from arising. That same caution may constrain the growth of (sound) lending to the private sector below what it might have been, with a greater willingness to privatise and make use of foreign banking expertise.

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