The Current State of Ethiopian Financial Sector and Its Regulation: What is New after a Decade and Half Strategy of Gradualism in Reform, 2001-2017

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The Current State of Ethiopian Financial Sector and Its Regulation: What is New after a Decade and Half Strategy of Gradualism in Reform, 2001-2017.

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Abstract

Ethiopia is one of a number of SSA economies that adopted state-led development strategies in the 1970s (others include Angola and Mozambique), and suffered from intense conflict (leading to the fall of the Derg regime in 1991). The then new government was therefore faced with the twin tasks of reconstructing the economy, and embarking on the transition to a market economy in early 1990s. As part of this process, state banks have been reorganised, the role of the private sector in the financial system has been expanded, interest-rate controls have been liberalized, and the central bank has been given new powers of financial supervision. Financial reform has been gradual, but nevertheless determined despite disagreement with the IMF over restrictions on the entry of foreign banks and the role of the largest state bank. This paper argues that gradual financial liberalization—while simultaneously investing in regulatory capacity—is the appropriate strategy for maintaining macro-economic stability and growth in Ethiopia. In this regard, the Chinese transition strategy—in which significant control was retained over the financial sector—can be a useful guide. However, since the sector cannot be protected forever and new and complex liberalization demands are in the horizon, the study suggests a time-specific strategy of capacity building for regulating and supervising the sector with cautious and partial opening of the sector using different modalities such as joint-ventures and management contract with the objective of efficiency, stability, shared growth and local ownership.

Keywords: sub-Saharan Africa, Ethiopia, conflict, economic reform, financial sector, Banks, Banking Regulation and Supervision

JEL classification: O10, O55

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I. Introduction

In 2001, Alemayehu and Addison (2001)[1] argued that gradual financial liberalization—while simultaneously investing in regulatory capacity—is the appropriate strategy for maintaining macro-financial stability and growth in Ethiopia. They also noted the Chinese transition strategy—in which significant control was retained over the financial sector—can be a useful guide to strategy design in SSA, provided that rent-seeking can be contained. In this study, we will be asking what is new in the last decade and half in this arena. We also examine if the argument noted is still valid. For the sake of comparability with the previous study, we have maintained the structure and historical information of the earlier paper, in this new version.

Successful reconstruction and development both require financial institutions capable of mobilizing resources, in particular domestic savings, and channeling them into high- return investments. But, as the case of Ethiopia shows, the creation of a sound financial system together with an appropriate regulatory framework is not a straightforward task. During the era of state socialism (1974 to 1991), Ethiopia's financial institutions were charged with executing the national economic plan; state enterprises received bank finance in accordance with the plan's priorities. This system, based on the template of the Soviet Union, saw little need to develop the tools and techniques of financial regulation and supervision found in market-based financial systems. With the overthrow of the Derg Regime in 1991, Ethiopia began its transition to a market economy. This transition has had profound implications for the financial system. New financial institutions have emerged, the role of the private sector in the financial system has been expanded, and the role of the central bank is being reformulated.

The government's strategy for financial development is characterized by gradualism— the financial sector consisted of a mix of private and public entities—and a strong emphasis on maintaining macro-economic stability. This is in contrast to Mozambique, where state banks were rapidly privatized (Addison and de Sousa 1999). Private Banks and insurance companies have been incorporated alongside restructured state banks in Ethiopia, and interest rates have been liberalized in two stages. Simultaneously, the strategy has aimed to strengthen domestic financial capacity as well as the central bank's capacity for prudential regulation and supervision before further liberalization is enacted. In contrast to Mozambique, restrictions on the entry of foreign banks have been retained. In the eyes of the IMF this strategy is too slow. However, the unsatisfactory transitions in Eastern Europe and the Former Soviet Union (FSU) and financial distress following liberalization elsewhere in the world (in the late 1990s in Asia) highlight the dangers of rapid financial liberalization when regulatory frameworks are still underdeveloped.

This paper explores the issues. It begins, in section 2, by setting out the main features of Ethiopia's financial development prior to 1991, focusing in particular on the policies of the Derg. This sets the scene for the summary and analysis in section 3 of the financial reforms undertaken since the fall of the Derg and the coming of the current government in 1991/92. Section 4 considers important regulatory issues, and section 5 discusses second-phase financial reforms and the disagreement with the IMF. In all these sections the progress made in reform to date is also documented. Section 6 focuses on the critical issue of reform speed and sequencing. Section 7 concludes by highlighting the relevance to

[1] In 2001 Alemayehu Geda and Tony Addison, have attempted to offer the general picture of the Ethiopian financial sector and its regulation at the onset of liberalization. That study, not only attracted a wide reading (over 10,000 reads in one year and in one site, researchgate, in 2016), but also the authors got frequent queries for an update of this study from all corners, including a number of private sector actors –hence, the reason for this update.

Ethiopia of different types of transition strategy, including that of China.

II. Financial Development Prior to 1991

The establishment of the Abyssinian Bank in 1905 marked the start of modern banking in Ethiopia. The financial sector was dominated by foreign ownership until the Abyssinian Bank was nationalized in 1931 and renamed the Bank of Ethiopia, thereby becoming the first bank to be nationally owned in Africa (Belay Gedey 1990: 83, Befekadu Degefe 1995: 234). Further financial institutions were established during the Italian five years occupations in the late 1930s. In 1943 the State Bank of Ethiopia was founded, despite considerable British opposition (see Befekadu Degefe 1995, for an interesting neo-colonial story). Resistance to foreign control of the financial system has therefore been a longstanding theme in Ethiopia's banking history, including arguments by the countries famous economist in the last century - Gebre-Hiwot Baykedagn in 1920s - and it still is an influence today.

The State Bank of Ethiopia operated as both a commercial and central bank until 1963 when it was dissolved to form the central bank, the National Bank of Ethiopia (NBE), and the Commercial Bank of Ethiopia (CBE). A number of other private financial institutions were also established during the 1960s. The structure of Ethiopia's financial system therefore resembled that of other African countries at this time.

All of this changed with the overthrow of the monarchy of Haile Selassie in 1974. Under the *Derg* (meaning the committee [of solders] in Amharic) regime all privately owned financial institutions including three commercial banks, thirteen insurance companies and two non-bank financial intermediaries were nationalized on 1 January 1975 (Befekadu Degefe 1995: 273, Harvey 1996). The NBE continued its functions as a central bank, although the directives of the planning system now circumscribed its activities. The NBE fixed both deposit and loan rates (both of which were set at very low levels), administered the allocation of foreign exchange (all of which had to be surrendered to NBE), and directly financed the fiscal deficit (NBE 1996a). NBE's bank supervision and regulation was largely restricted to off-site inspection of a few bank branches.

By allocating credit and foreign exchange in favour of the state sector, NBE constituted a powerful tool for imposing state-led development. Credit to the private sector fell from nearly 100 per cent of total bank credit under the monarchy to only 40 per cent under the Derg (Di Antonio 1988). The Agriculture and Industrial Development Bank (known today as the Development Bank of Ethiopia) allocated 68 per cent of its resources to State farms (Di Antonio 1988: 74). State banks undertook little in the way of any financial or economic analysis of prospective projects. Since loan collateral was not required from state-owned enterprises (SOEs) and the government implicitly covered losses by fiscal subventions, state banks developed very little capacity to appraise the riskiness of their balance sheets. Moreover, the inefficiency of the state financial system manifested itself in excess liquidity; the ratio of liquid reserves to CBE's total net deposits averaged 25 per cent during this time (IMF 1999b: 28).

III. Economic transition and financial reform

With the fall of the Derg in 1991, the new government (the Ethiopian Revolutionary Democratic Front, EPRDF, which is still in power) faced the difficult tasks of organizing the demobilization as well as starting the transition to a market economy. There is a considerable literature on the policy changes enacted since 1991 to which the reader is referred (see for instance Hansson 1995; Alemayehu 2005, 2008). Here, we confine ourselves to summarising the main characteristics of the transition in order to place the financial reforms in context.

Economic reform began soon after the new government took power. War and the Derg's policies had left a crippled economy and an impoverished people. Fiscal policy aimed to raise revenue and to reduce the fiscal deficit which became a source of inflation. Structural reforms concentrated on lifting most domestic price controls, reducing import tariffs, and moving to a market-based system of foreign exchange allocation. Exchange-rate reform, which was an essential first step in achieving economic recovery, began in October 1992 with a devaluation of 140 per cent from 2.07 Birr to the dollar (the rate at which it was fixed for nearly two decades) to 5 Birr to the dollar. The devaluation's size was justified by the substantial premium on the parallel market, which was 238 per cent at one point. A foreign exchange auction system was introduced in 1993 (Aron 1998). The auction-system initially worked alongside the official (fixed) exchange rate which applied to critical imports and external debt-service, but the system was further liberalized over 1993-96. Once export earnings had recovered sufficiently the negative import list was abolished and controls requiring the surrender of foreign exchange were liberalized. Reform of the exchange and trade system corrected major policy distortions of the Derg era, in particular by removing the disincentive to produce exportables inherent in the pre-1992 currency overvaluation. Today, in 2016, the government is following a managed floating exchange rate policy. Until recently, despite a significant gap between imports and exports, where exports financing only 20% of imports by 2016 – the parallel market premium remained insignificant being about Birr 0.20- to 0.30 (1.5%). This premium has dramatically increased to about 5 Birr (about 23 %) in January, 2017 – doubling from 14% in November 2016. This has happened following the relapse to violent conflict in the country after nearly a decade of relative peace.

Ethiopia has received large aid inflows in support of its reconstruction and transition programmes; the country was the largest World Bank client in SSA in 1998. The early reforms were supported by a World Bank structural adjustment credit (SAC) and an IMF Enhanced Structural Adjustment Facility (ESAF) over 1993 to 1995. A second ESAF was launched in 1996, but ran into trouble in 1997, before resuming in 1998 (see section 5). Still the country is in the favorite list of IFIs and the Western developed countries getting nearly an average aid inflow of USD 3 billion per year by 2015/2016. In addition, there is a significant inflow of capital from the emerging South - Chain, Turkey and India being the most important ones – the combined figure that came from China alone during 2005-2011 being about 17 billion USD, which is a third to half of the GDP of the country. The informal and formal inflow of remittance is also estimated at USD 3.8 billion in 2016 – this is significant compared to total export of the country which is just USD 3 billion in the same year. This is accompanied by significant capital flight, however. On the average there is an annual capital flight of about USD 1 billion (in some years such as 2010 this has reach as high as USD 4 billion) since the fall of the Derg – the cumulative capital flight since the fall of the Derg being about USD 21.4 billion – nearly half the annual GDP (Alemayehu and Addis, 2016).

The economy has responded reasonably well to reform despite the structural constraints characteristic of a predominantly agrarian economy (large annual fluctuations in GDP occur in response to weather variations), terms of trade shocks (the decline in the coffee price) and the 1998-2000 war with Eritrea (see Alemayehu, 2008). Table 1a shows the main trends following the reform in the 1990s, and Table 1b gives the recent picture. Fiscal and monetary policies have kept inflation low, and exchange rate and trade reforms have stimulated exports until the year 2005 (IMF 1999a; Alemayehu and Kibrom, 2011). However, the external deficit has deteriorated with the rise in imports (related to reconstruction), and the alarming deterioration in debt-service made Ethiopia a candidate for official debt-relief under the Heavily Indebted Poor Countries (HIPC) initiative. The indebtedness is back in the year 2016 despite a significant debt cancelation with the HIPC initiative (Table 1b). Inflation also became a major macro challenge since the 2005 violent election and its aftermath (see Alemayehu and Kibrom, 2011).

Following this early period of post-reform Ethiopia in the 1990s, economic growth has been very good (extremely good if we take the official statics which shows a double digit growth for a decade, Table 1b). However, that official figure needs to be taken cautiously (see IMF, 2012; Alemayehu and Addis, 2015). Notwithstanding this, the Ethiopian economy has been characterized by lack of structural transformation (the share of industry being about 12 % of the GDP for nearly four decades), chronic foreign exchange constraint, stagnant export and growing imports, as well as an alarming level of domestic and external debt (Table 1b). On the positive side, the government has invested heavily on developing the infrastructure of the country and achieved significant results (see Alemayehu and Addis, 2015).

Table 1a: Ethiopia: major macroeconomic trends following the Reform in 1990s

	1991/92	1992/93	1993/94	1994/95	1995/96	1996/97	1997/98
Real GDP growth rate (%)	-3.6	12	1.6	5.2	12.7	5.6	0.5
Inflation Rate (%)	21	10	1.2	13.3	0.9	0.8*	2.3*
Exchange Rate, Birr/US$		5.01	5.77	6.25	6.32	6.47	6.80
Exchange Rate, Birr/US$		7.6	7.05	7.30	7.64	7.16	7.23
Trade Balance (M-X), % GDP	-6.2	-8.6	-10.1	-9.7	-12.5	-10.8	-13.4
Debt to GNP ratio (%)**	63.9	65.7	157.6	208.5	180.3	168.9	159

** Based on World Bank (1999) including Ruble denominated debt.
Sources: Alemayehu (2011), Alemayehu Geda (1999) MEDaC (1998), and World Bank (1999).

Table 1b: Recent Major Indicators of the Macroeconomic Environment 2000-2015

Sector/Indicator	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15
Real GDP Growth Rate (%)*	11.5	11.7	11.0	9.8	10.3	11.4	8.7	9.9	10.3[7]	10.2[6]
Inflation (CPI, % Change)	10.6	15.8	25.3	36.4	2.8	18.1	34.1	13.5	8.1	7.6
Exchang rate Birr/ USD					12.9	16.1	17.3	18.2	19.1	20.1
Gross Domestic Saving (%GDP)	8.3	12.4	9.2	9.8	9.3	17.2^	19.2^	17.6	20.5	21.89
Gross Domestic Investment (% of GDP)	27.6	24.2	24.5	24.9	27.0	32.1	37.1	39.1	38.0	39.3
Trade deficit [M-X] GDP ratio (%)	-22.9	-19.6	-19,6	-18.4	-19.5	-14.8	-17.8	-16.5	-17.5	-17.5
External Debt to GDP ratio (%)**			32.5	26.9	27.5	26.8	25.7	27.4	28.6	29.1

Source: MOFED (2012) & NBE (2012).
^= unexplained huge jump; also the saving in the banking sector as % of GDP is only 10% * IMF figures in [ ]
** Domestic debt is as big as external debt, being about 50% of the total debt in the last 5 years.

3.1 The new private banks

Financial reform began in earnest in 1994. NBE's role in overseeing the commercial banks was codified. Sector-specific interest rates administered by NBE were also ended, and replaced with a minimum deposit rate (10 per cent) and a maximum lending rate (15 per cent). The domestic private sector was permitted to enter the banking and insurance business (foreign financial institutions are not yet permitted to invest). The response to these reforms has been promising. There were 6 private banks at the initial stage of this reform and this has grown to 19 by 2016. There were also 8 private insurance companies at the initial sage of the reform. This has grown to 14 by 2016.

The market shares of the private banks, although growing, still remain small relative to those of the publicly owned CBE (see Tables 2 and 3). CBE dominates the deposit market (its share was 87.6 per cent in 1995/96) a reflection of CBE's national coverage and its role as banker for many SOEs. However, CBE's dominance in the loan market has eroded, its share having fallen to 56.3 per cent in 1997/98 from 83.9 per cent in 1995/96 (Table 2) and to 51.2 % in 2015. Another public institution, the Development Bank of Ethiopia, has captured some of this share, but the new private banks have raised their share to 17.3 per cent (Table 2) at this initial stage of the reform. This has reached 34.8% in 2015. Nevertheless, the market dominance of CBE has proved to be a contentious issue, and one that we return to in section 5.

Table 2: Ethiopia: distribution of total deposits and loans in the banking system in early days o reform (percentage shares)

	1995/96		1996/97		1997/98	
	Deposits	Loans	Deposits	Loans	Deposits	Loans
Commercial Bank of Ethiopia	93.2	83.9	91.6	73.7	87.6	56.3
Development Bank of Ethiopia	0.1	10.9	0.3	15.7	3.6	21.3
Construction and Business Bank	3.65	5.12	4	4.3	3.2	4.9
Private Banks	3	0	4.2	6.3	5.6	17.3

Source: MEDaC (1998).

Changes on the supply-side of the loan market have been paralleled by important changes on the demand side. Lending to public enterprises has fallen absolutely and as a share of total loans in this early phase of the reform. Public enterprises accounted for only 3.6 per cent of total bank credit by the end of the 1990s. This reflects the privatization of 197 mostly small- to medium- scale SOEs and 27 large state-owned farms, from 1996 onwards (IMF 1999b). The next phase of privatization saw the divestiture of 110 SOEs, thereby accelerating the decline in the share of bank credit taken by the public sector. This has dramatically increased to about 30% in 2015, however – indicating the reversal of the government policy after the end of the 1990s. Credit demand by the private sector has grown—particularly to finance imports as well as wholesale and retail trade (see Figures 1a and 1b)—and the private sector's share has risen from a low of 40 per cent during the Derg to over 80 per cent by the end of the 1990s – this has declined to 56% by 2015, however (Table 3b). This reflects the liberalization of business licensing which has encourage private-sector growth, the reduction in import tariffs (thereby raising credit demand to finance imports), and the general upturn in activity as the economy reconstructed between 1991 and 1998 and grew faster since then. In terms of sector credit, as can be read from Figures 1a and 1b, at the initial period of the reform lending to the government has fallen sharply while lending to the import sector saw the largest growth (Figure 1a). This has changed recently. The biggest lending growth is now for the industrial sector (followed by the international trade). Lending to the government sector has declined to take about 10% in 2015 (Figure 1b) – which is a significant decline compared to about 22% at the end of the 1990s (see Figure 1a).

Outstanding loans and advances, commercial bank of Ethiopia (after reform)

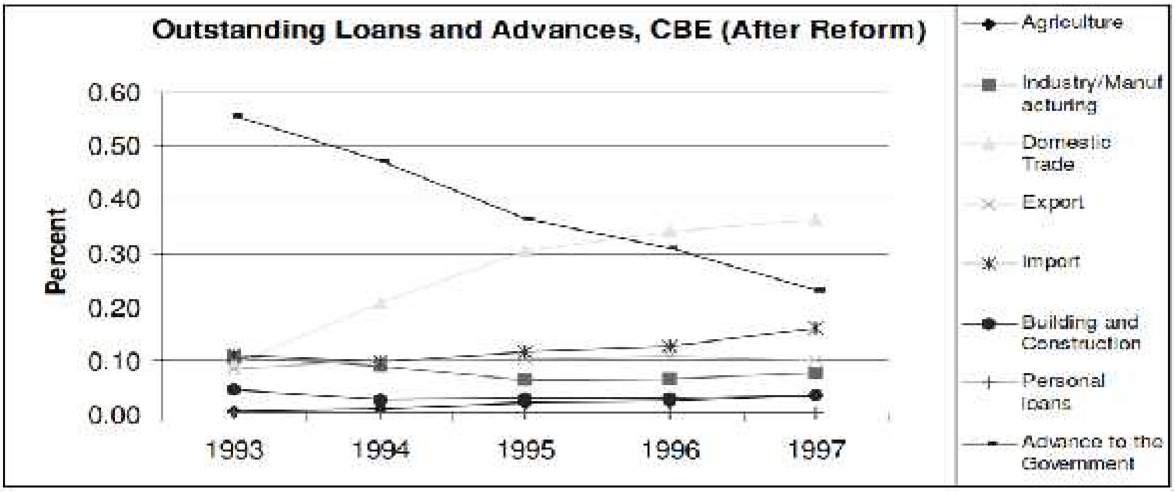
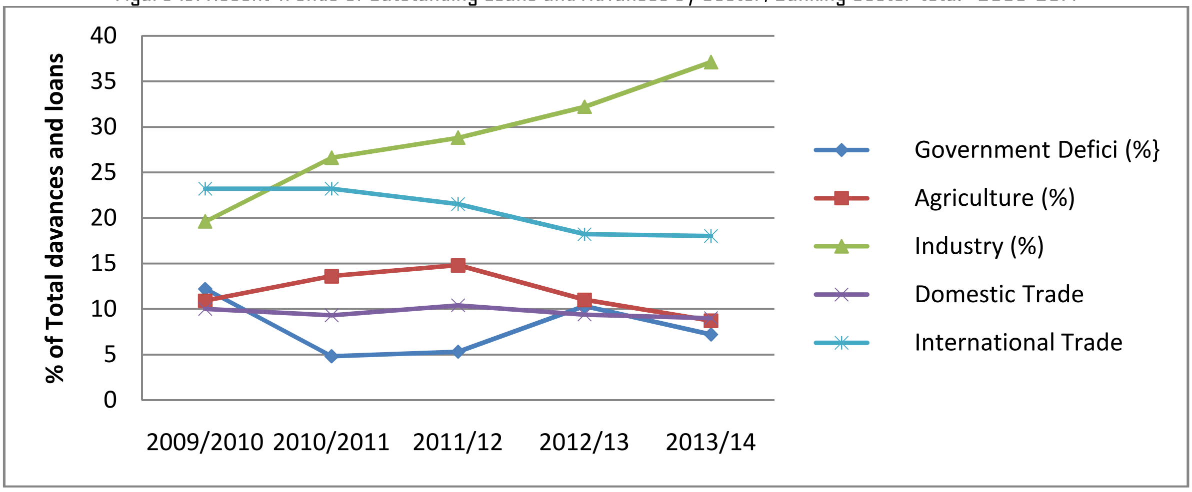


Figure 1b: Recent Trends of Outstanding Loans and Advances by Sector, Banking Sector total -2009-2014



3.1,1 Recent Financial Sector Development

Today the major financial institutions operating in the country are banks, insurance companies and micro-finance institutions (NBE, 2015). The number of banks operating in the country by the end of 2015 reached a total of 19, of which 16 are private commercial banks. The number of bank branch networks and hence physical reach of the sector is increasing very fast. By 2015, this number reached a total of 2, 693, the public banks making about 42 per cent (the private banks share being 58 per cent). Among publicly owned banks the CBE still takes the lion's share of about 40.7 percent (977 its own bank branches and 120 branches of the CBB that it recently absorbed). This is followed by private banks: Awash International Bank (207), Dashen Bank (164), Abyssinia Bank (136 branches) and Wegagen Bank (119 branches) being the top four as of June 2015.The total capital of the banking sector has also reached Birr 31.54 billion – the share of public and private banks being 43.5 and 56.5 percent, respectively (NBE, 2015). This latter growth in the share of the private banks is related to the surge in the capitalization of private banks following the NBE regulation that raised these banks' minimum paid up and start up capital to be Birr 75 and 500 million, respectively. Thus, in the last decade private banks have grown significantly, eroding the dominant position of the CBE.

The total amount of resources mobilized by the banking sector through deposit, loan collection and borrowing in 2014/15 has reached Birr 138.76 billion. This is more than double the amount mobilized in 2009/10. By 2014/15 public banks have accounted for 58 percent of the resources mobilized – aggressive branch expansion and the government policy of providing loan for low cost housing conditional on having some minimum saving at CBE explains this surge in deposit mobilization. Similarly, in terms of loans and advances, by 2014/15, a total amount of Birr 75.5 billion is disbursed to various economic sectors by all banks taken altogether. The public banks, the dominant being CBE, dominate this disbursement of loans, accounting for about 55.5 percent of the total -this averages to about 60 per cent in the last five years (NBE, 2015; Table 3a).

Table 3a Total Resource Mobilization and disbursement in millions of Birr

	2009/2010	2010/11	2011/2012	2012/2013	2013/14
Total Resources Mobilized	48,146	76,488	89,193	98,074	111,425.3
Public Banks share, %	51	61	70	63	63.0
Private Banks share in, %	49	39	30	37	37.0
Loans and Advances by Lenderes (by Disbursement)	28,905	42,208	56,102	54,252	59,965.4
Public Banks	13,939	21,956	36,949	33,250	38,937.9
[Share of total, %]	48	52	66	61	64.9
[of which CBE share, %)	37	42	57	50	53.7
Private Banks total	14,966	20,252	19,153	21,002	21,027.5
[Share of total, %]	51	48	32	39	35.1

Source: Author's Computation based on NBE, Annual Report (2013& 2014),

The total value of outstanding loans and advances of the banking sector steadily increased over the last five years (Table 3b).By 2013/14, a total of Birr 181.3 billion was recorded as an outstanding claim on the various sectors of the economy. The share of the industrial sector in this was the highest, claiming about 37 percent – perhaps reflecting the government's recent policy focus on the industrial sector. This is followed by the international trade and agricultural sectors. From institutional borrowers' perspective, the share of outstanding loans and advances to private business and individuals was the highest and stood in the range of 55-67 percent in the last five years. This is followed, though at distant, by the public enterprises (14-30 percent), and the central government (5-12 percent) (Table 3b).

Table 3b Loans and advances by sector and institutional borrowers in Millions of Birr

	2009/2010	2010/2011	2011/12	2012/13	2013/14
Loans and Advanced by Sector	62,292.2	77,690.5	116,346.1	151,344.3	181,327.4
Government Defici (%}	12.2	4.8	5.3	10.3	7.2
Agriculture (%)	10.9	13.6	14.8	11.0	8.7
Industry (%)	19.6	26.6	28.8	32.2	37.1
Domestic Trade	10.0	9.3	10.4	9.4	9.0
International Trade	23.2	23.2	21.5	18.2	18.0
Loans and Advances by Institutional Borrowers	62,292.2	77,690.5	116,346.1	151,344.3	181,327.4
Central government (%)	12.2	4.8	5.3	10.3	7.2
Public Enterprices (%)	13.6	17.6	23.8	27.0	29.6
Cooperatives(%)	8.2	10.8	11.8	8.1	7.0
Private & Individuals	65.7	66.8	58.9	54.5	56.2
Inter-bank Lending	0.4	0.0	0.2	0.1	0.04

Source: Authors' Computation based on NBE, Annual Report (2013& 2014),

In sum, in the past five years the key monetary policy target of the government, inflation, had emerged as a policy challenge. Inflation using the official data has, however, declined from the high of 34 percent in 2011/12 to 8.5 percent in June 2015. This decline is chiefly attributed to the tight monetary policy that the government pursued lately. Broad money growth declined from the period's high of 39 percent in 2010/11 to 26.5 percent in 2013/14. Similarly, the base money has significantly declined in the last three years with 19 percent growth in 2013/14, chiefly through sterilization. However, domestic credit, especially to non-central government has grown significantly in the last five years, from a low of 11 percent in 2008/09 to 39.5 percent in 2011/12, before coming to a relatively lower growth figure of 28.4 percent in 2013/14. This is primarily driven by government borrowing for financing the activities of public and semi-public (or party owned) enterprises. Thus, it is imperative to address the challenge of coordinating the link between fiscal and monetary policy and debt management to make monetary policy effective and the financial sector and the macroeconomy stable (see Alemayehu and Addis, 2015).

Lax monetary policy and the resultant inflation had also implications for the banking and external sectors. A single digit and lower level of inflation is required not only to have a competitive real exchange rate but also to reverse the current negative level of deposit and lending rate that ranged from -31.9 to -24.2 percent (in 2008/09) to -5.0 to -3.0 percent (in 2016), respectively, in the last 5 years[2]. The last five years also witnessed significant expansion of the banking sector, both public and private, as noted above. This has shown itself in significant domestic resource mobilization and provision of loans and advances. This development is, however, still dominated by public banks, in particular by that of the CBE. This needs to be complemented by similar expansion of the private sector to address the shallowness of the financial sector as can be inferred, inter alia, from the M2/GDP ratio of just 28 percent in 2015 compared, for instance, to over 50 percent in Kenya. The role of mobile-banking (called M-Pesa in Kenya) in this development has been significant in Kenya and it is imperative to learn from this excellent Kenyan experience.

In sum, recent IMF (2014) study using financial soundness indicators (FSIs) revealed that there are no indications of immediate risks to the health of the banking sector in Ethiopia. The study noted, on average, the banks appear to be well-capitalized and profitable, their capital adequacy ratio stood at 17.5 percent, as opposed to the 8 percent minimum required[3]. Return on assets and return on equity showed comfortable performance, at 3.1 and 44.6 percent, respectively. Asset quality has also improved, the nonperforming loans being less than 3 percent of banks' total loan portfolio. Given, the lack of financial depth and less sophisticated nature of the financial sector, the NBE has also no problem in managing and regulating the sector, according to the IMF. The IMF study, however, cautions the systemic importance of the CBE and the concentration of CBE's operation through large exposures to single entities - the public sector.

From a systemic risk perspective it is also worth discussing the DBE as it generally does not obey to sound finance and regulatory practice both historically and today. This was the case during the Derg period through its financing of loss making state enterprises, especially state farms, and writing-off their loans - where arrears of DBE were on average 75% of total principal outstanding before the 1992 reform (Alemayehu, 2011). During the current government DBE was financing party-owned and politically connected firms in a significant way – to the tune of over 60% of their project costs and writing-off some of these loans and lending again to the same firms. In a nutshell, DBE's activities are more political than

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[2] The only exception here is the year 2009/10 when both rates were positive owing to the unusual low inflation rate of 3 percent in that year; and last year for lending rate (see Alemayehu and Addis, 2015).

[3] This IMF conclusion is, however, unwarranted. In 2016 the government acknowledged a serious problem with the CBE's capital adequacy ratio which is about 4% and below the 8% global bench mark (where the loan to capital ratio grew up from 400% to over 800% in five years – if other liabilities taken in the computation this could go as high 2016%). The government, thus, decided to issue a "corporate bond" aimed at raising the paid up capital of the CBE from the current level of 13 billion to 40 billion (The Reporter, Tire 3/2009: Jan 11/2017).

economic and are not amenable for evaluation from sound banking and regulatory practice perspective – thus political analysis, than economics, gives more insight[4]. This is another systemic risk in Ethiopian banking sector. Thus, unless the government pursues impartial and professional sound surveillance and closely monitors their lending activity to public and semi-public entities; and, more importantly, reduces its own pressure on the public banks to finance such unviable public and semi-public owned projects, a systemic banking sector risk is unavoidable.

Notwithstanding the general positive outlook alluded above, the financial sector in the country is still shallow and reserved for local investors who are thus protected from global competition and best practice in the industry. It is also dominated by the state owned CBE. Government policy is also biased to the public banks as the governments lending cap on private banks, holding of its big accounts in the public banks and its policy of linking government low income housing loan provision to having a saving account at the CBE show. In addition to the systemic risks and connected lending noted, these are the challenges of the financial sector that need to be addressed. Finally, although we have argued for gradual liberalization of the sector more than a decade ago (Addison and Alemayehu, 2001), it seems the government has stalled any form of reform in the sector. We have discussed this issue in the next sections.

IV. Regulating the New Financial Sector

Financial markets are inherently imperfect, characterized as they are by asymmetric information in the relationship of borrower to lender (Bascom 1994, Stiglitz 1994). In Ethiopia this imperfection is aggravated by the institutional under-investment of the Derg era. It is after the fall of the Derg, the public and private banks began developing the capacity to evaluate loan risks in the context of a market economy and are yet to offer the full range of financial instruments required by potential clients (which vary from large commercial enterprises to micro-entrepreneurs). The supporting framework of commercial law and accounting practice—both essential to sound financial systems—are highly underdeveloped in Ethiopia. For these reasons, investment in NBE's capacity to regulate the financial system in the public interest must get the highest priority.

Under the Derg, regulation consisted of enforcing interest-rate controls and the allocation of credit and foreign exchange according to the dictates of the planners. Thus, it was a must for NBE to learn the skills of prudential regulation and supervision appropriate to a market-based financial system[5]. This requires the monitoring of capital adequacy and restrictions on bank portfolio choices (to avoid large loan exposures and 'insider lending'). It also requires the imposition of disclosure standards (including the publication of audited accounts), the provision of deposit insurance and lender of the last resort facilities and intervention in distressed banks (Bascom 1994:170, Polizatto 1993: 173). This is a challenging set of tasks, and the necessary institutions take years to build (see Sheng 1993). In 1996, NBE established a new division to undertake regulation and supervision. Its

[4] Although it is not as pervasive as in the DBE, such politically decided and invariably not rigorously evaluated and executed loans to party-owned and party-affiliated firms (and their subsequent write-off or transfers from CBE to DBE through the highest level political orders) could also be observed at the CBE. In 2001 CBE's problematic loan to party-owned firms to the tune of 2.8 billion was transferred from CBE to DBE, apparently under the pressure of the IMF to reduce the CBE's NPL. This is at a time when DBE's own NPL is about 50% of its total loan (The Reporter, December 12, 2001; see also Ermias (2016) for a book length treatment of the political-economy of such loans and the documentary evidence about it in the appendix to the Book).

[5] Polizatto (1993: 174) defines prudential regulation as the '... codification of public policy towards banks, while banking supervision is the government's means of ensuring the bank's compliance with public policy'.

first task was to draw up a set of guidelines (NBE 1996b). These codify what is expected of banks and of NBE itself. Among its tasks, NBE licenses and approves external auditors to prepare regular accounts for financial institutions; this is important since private-sector capacity in auditing is itself a nascent and therefore inexperienced industry in Ethiopia. NBE's supervision consists of both off-site surveillance and on-site examination.

NBE's off-site surveillance mechanisms require banks to submit key financial data— such as the composition of lending and the scale of non-performing loans—on a regular basis in order to identify all the risks to which each bank is exposed. Commercial banks are legally required to make 100 per cent provision against ‘bad’ loans (those with no collateral) and 50 per cent provision for 'doubtful' loans (those for which repayment is more than one year later and for which there is no adequate security). Close attention is paid to credit concentration—over-exposure to a small number of borrowers has undermined many developing financial systems—and the total liability of any one borrower must not exceed 10 per cent of the net worth of the bank according to NBE’s earlier regulations. This also encourages banks to seek out new customers, an incentive that is important to raising private sector investment and thereby achieving reconstruction. This has been relaxed currently, however, as the maximum level of credit that commercial banks can provide is set not exceed 25% of their total capital for single borrower and 15% of their total capital for a related party[6].

To maintain further the stability of the financial sector the NBE has also issued various directives in the last decade and half. Thus, the NBE, first, stipulated the maximum outstanding loan relative to the total capital not exceed 35 per cent of the total capital of the commercial bank in question. In addition, it has established a unit that provides credit history services to commercial banks on individual applicant so as to reduce ex-post risks. Second, to reduce ex-ante risks, it has issued a loan provision directive that force banks to craft and work out Non-Performing Loan (NPL) reduction plan. The decline in non-performing loan from the high of 6.8 per cent in 2008 to 1.4 per cent in 2012 could also be the result of this rule. This is excellent performance compared to the trend of NPL in SSA that ranges from 6.5 to 9.6 percent for the same period (WB, 2013). Third, the NBE has also issued various directives with the aim of reducing other ex-ante risks. These includes: reserve requirements (15%), liquidity requirements (25%), minimum capital adequacy ratio (of 12%), minimum paid up capital (of 75 million Birr out of 500 million startup), among others. It has also used these instruments to fight inflation which became a serious problem since 2005 and reversed them once inflation is abated. For instance, following the success in getting down the inflation in 2012/13, the NBE revised the reserve requirement downwards to 10% in 2012 and further down to 5% in 2013 and liquidity requirement to 20% in 2012. Finally, with regard to Basel Accord, the NBE is not using Basel accords phase by phase. Instead, it simply adopts instruments as it sees it fits the Ethiopian context (Getnet, 2014).

On the liabilities side, NBE's directives require banks to maintain liquid assets of not less than 15 per cent of their total demand, savings and time deposits with less than one month to maturity. This has been increased to 20 percent since 2007. Banks must also report their weekly liquidity position to NBE as a further safeguard measure to protect depositors. The information that NBE collects from its off-site surveillance is used to score the bank on its

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

performance ranging from 1 (unsatisfactory) to 5 (strong)—and the results are reported to NBE's Governor and its board. Off-site surveillance is only as good as the reports that banks submit to NBE. Therefore NBE also has comprehensive on-site examination powers under which banks are subject to annual inspection, and banks could be visited at any time without notice.

Finally, although many African countries have moved to an open capital account, the closed capital account policy of the NBE has also helped to maintain the stability of the financial sector. This is much more important in Ethiopia in view of the serious foreign exchange shortage in the country. Although this shortage suggests the need to open the capital account to attract capital, if such capital is not forthcoming owing to lack of fundamentals, the exchange rate could depreciate significantly leading to significant inflation (in Ethiopia, the elasticity of inflation with respect to depreciation is closer to 2). Both inflation and depreciation would lead to immediate fiscal deficit owing to huge public sector with strong demand for imports which further aggravates inflation through possible monetization (see Alemayehu and Kibrom, 2011). This policy has also importance in helping avoid toxic capital inflows, as the recent experience of emerging economies with capital control shows. Emerging economies with capital control regime were successful in preventing the impact of the recent world financial crisis as the control enabled them to prevent the entry of toxic financing (Subbaro, 2013). In particular, the price-based instruments of capital control (compared to the quantity based) are found to be important in these countries.

Therefore on paper, NBE has a comprehensive set of supervisory and regulatory tools at its disposal. However, effective supervision needs considerable human capital investment; Caprio (1996: 4) notes that '... experienced supervisors estimate that it could take many countries 5-10 years of substantial training before their supervisory skills would be near the capacity found in industrial countries'. Our observation also shows that even 15 years was not enough to have such capacity in countries like Ethiopia. NBE's supervision department is still short of the necessary human and financial resources as it was over a decade ago. The non-existence of foreign banks may have also reduced the incentive by NBE authorities to adopt the Basel accord and market based policy tools in full. Indeed, this sophisticated method of supervision requires capacity which is not found in full at the NBE. Those abilities are in demand by the private sector itself too (including the banks), and therefore ways must be found to recruit and retain experienced staff in NBE in a continuous and sustainable manner (donors, including the IMF, have provided assistance, mainly in the form of training). Moreover, the valuation of bank assets has not been a straightforward process. Nevertheless, NBE's supervision division has 'teeth'; in 1997 it pressed CBE to tighten its loan collection procedures, and by 1998 CBE's stock of non-performing loans was down to 24 per cent of total loans compared with 35.8 per cent of total loans in 1996 (GOE-IMF 1998)[7]. The NPL of the CBE today is a comfortable 1.4% (in 2014) although it is vulnerable to systemic risk related to its operation with the public (and semi-public) sector. In general, today, thanks to an array of regulatory requirements of the NBE, the banking sector performances are within the limits set by NBE indicators outline above (see Getnet, 2014). This doesn't imply, however, it is in a good shape to manage further liberalization as the controls are many and managing them, once liberalised, is getting sophisticated by the day.

[7] The scales of CBE's non-performing loans is not unusual in transition economies—see Gros and Steinherr (1995: 208) on Eastern Europe and the FSU—reflecting as it does the inheritance of ill-conceived lending from the time of the Derg. Since such ill-conceived lending during the EPRDF period had been relegated to the DBE, which, in turn, written-off such loans, this must have also helped the CBE's good performance with regard to NPL. Moreover, the pressure from the IMF on the government has also helped the NBE to have such "teeth".

V. The second phase of financial reform

After the 1994 financial liberalization measures, the authorities concentrated their efforts on building regulatory capacity in the financial sector as well as on other priority areas of economic transition, in particular further liberalization of the foreign exchange system and trade liberalization. But financial liberalization accelerated again when loan interest rates were decontrolled in January 1998. A minimum floor on bank deposit rates is retained so that deposit rates remain positive in real terms. This floor ensures that the excess liquidity of the banks does not lead them to impose low rates on depositors, thereby undermining the recovery of the savings rate (which rose from 2.7 per cent of GDP in 1991 to a high of 8.6 per cent in 1997, before falling back again to 4.5 per cent in 1999). The floor can be removed when excess liquidity is finally eliminated. This is not done even by 2016, however.

With a stronger banking system and an improving macro-economic situation, further institutional investment could take place. For example, an interbank foreign exchange market began operation in 1998, enabling banks to manage their foreign-exchange requirements more efficiently. At the same time, a framework was established for an interbank money market, in which banks and non-bank financial institutions can borrow and lend at market-determined rates. This measure should reduce the level of excess liquidity in the banking system; in particular CBE will be able to lend overnight to other banks thereby enabling them to meet any shortfalls in their operation. The interbank market could also facilitate indirect instruments of monetary policy (such as open market operations using government paper) to influence liquidity and interest rates (GOE-IMF 1998). However, by 2016 the interbank money market remained inactive since its introduction in 1998, partly, due to the existence of excess reserves in the banking system (NBE, 2015).

These steps are crucial to creating a modern, market-based, financial system. Nevertheless two problems arise. First, African inter-bank markets are often dominated by a small number of banks; this can result in oligopolistic practices that reduce market- efficiency and disadvantage smaller, and newer, banks—thereby constraining financial development. In Mozambique, for example, one commercial bank accounts for 70 to 80 per cent of the inter-bank exchange market (Lum and McDonald 1994). Similarly, the Zambian current condition shows that few banks dominate this market and such structure could easily bring about financial sector instability (Alemayehu and Weeks, 2016). It is therefore important for Ethiopia's regulators to closely monitor the efficiency of the interbank markets if it develops in the near future. Second, inter-bank transactions are uninsured, thereby creating a systemic risk (Dewatripont and Tirole 1994). Indeed, FSU interbank experiences highlight the dangers for Ethiopia. Former state banks flush with excess liquidity but inexperienced in lending directly to private enterprises, lent instead to new private banks in the belief that this was less risky (Roe *et al.* 1998: 18). But the poor quality of the loan portfolios of the new banks exposed the large banks to as much risk as direct lending, and the interbank market spread financial distress throughout the system.

5.1 Disagreement with the IMF

The second phase financial reforms took place against a background of disagreement between the IMF and the government over the financial sector. This led to the suspension of the second ESAF in October 1997 (the World Bank and the bilateral Donors continued to disburse). IMF criticism focused on two major issues. First, the IMF argued that CBE's share of the deposit and loan markets (see section 3) constrained competition; the Fund wanted CBE split up into three or four banks for privatization. Second, the Fund pressed the government to open the market to foreign banks, citing the example of Mozambique. Limitations on the operation of foreign exchange bureau were another source of disagreement.

The dispute was finally resolved with the announcement of further reforms in September 1998. The resulting Policy Framework Paper (PFP) sets a target to reduce CBE's non-performing loans to 15.4 per cent of total loans by the end of 1999 (GOE- IMF 1998). This continues the progress made since NBE's 1997 examination of CBE which reduced CBE's non-performing loans to 24 per cent of total loans (see section 4). CBE's compliance with NBE regulations is being tightened up, and its capital and reserves are to be increased. An external audit of CBE was also agreed, and this audit will guide further restructuring. The IMF continues to press for CBE's break up and privatization. The government has agreed to the privatization of the Construction and Business Bank [CBB]—the second largest commercial bank—but remains wary of privatizing CBE. It cites the improvement in CBE's performance since the NBE examination and the erosion of CBE's dominance in the loan market (Tables 2 and 3 shows a fall in CBE's market share to 56 per cent from nearly 84 per cent in 1995/96; and further to about 60 percent today). After a decade and half, in 2016, the government not only resisted the privatization of CBE but also decided to merge the CBB with the CBE – thus ending the former's existence.

Certainly experience elsewhere indicates that privatization does not automatically improve performance; the 1998 scandal involving the Uganda Commercial Bank is a case in point. Moreover, the World Bank's experience of financial reform in the FSU leads Roe *et al.* (1998: 8) to the conclusion that early privatization does little to improve the quality of the banking system and may be counterproductive when institutions are weak and prudential regulation is underdeveloped. Therefore it is by no means self- evident that Ethiopia should follow Mozambique's example of privatizing state banks early in the transition (and we are not out there for it even today, see below).

Be that as it may, the controversial issue of opening the financial system to foreign banks remains on the table. The benefits of opening include recapitalization of the banking system (a strong motivation for opening to foreign banks in Angola and Mozambique) and the transfer of modern banking technologies. However, although some (but certainly not all) foreign banks have considerable 'reputational capital'—and may therefore transfer high standards to Ethiopian partners—they can introduce new risks (such as excessive and unhedged short-term foreign borrowing) which the central bank has little experience in containing. Moreover, NBE faces considerable pressure in effectively supervising the financial system as it stands. At present, the procedures of the restructured state banks and the private banks are similar to those of CBE with which NBE supervisors are familiar. NBE also needs to build its capacity to grade the quality of foreign banks; some poor- quality Asian banks have set up in Africa's transition economies. Hence, the authorities are understandably cautious in opening up to foreign banks with unfamiliar procedures and potentially doubtful reputations. The ideology of using public banks in public and developmental interest is also at the heart of this government policy.

Thus, the disagreement with IMF continued to date - the range of issues for disagreement increasing over time. Currently, in addition to the restriction on the participation of non-citizens in the financial sector, the IMF is concerned because Ethiopia is exercising control on a number of capital transactions including capital market securities, money market instruments, collective investment securities, derivatives and other instruments, commercial credits, financial credits, guarantees and financial backup facilities, direct investment, liquidation of direct investment, real estate transactions, commercial banks and other credit institutions and institutional investors (IMF, 2012). Regarding the type of instrument used in such capital control, the current practice in Ethiopia is more towards quantity based capital account management instruments: prohibition, ceiling, or partial permit, etc. Derivative operations are prohibited, real estate transactions abroad are prohibited, there is a ceiling on net exposure in foreign currency, foreigners are not allowed to invest in domestic securities, equity investment by foreign firms is strictly regulated, residents are not allowed to invest abroad, financial institutions are not allowed to borrow from abroad, external loan and supplier credit are allowed to exporters and FDI firms only. Thus, it is understandable if the government worries about what will happen to the stability of the macro economy in general and the financial sector in particular if it lifts all these controls without a well equipped regulatory and supervision capacity.

In addition, recent trends point at an incipient foreign owned investment banking activities that are in the course of entering the country using the "equity finance"/ "investment banking" and "representative office" schemes. They may also, partly, be motivated by the desire to lay the ground for quick and effective action if the sector is opened, circumventing the regulation that restrict foreign participation in the financial sector. Thus, many, big and famous equity investments firms are becoming active in Ethiopia. This list includes global firms such as KKR, Blackstone Group, Hedge-fund managers (such Paul Tudor Jones who is planning to back a $2 billion geothermal power project financing); Bob Geldof's UK based firm, Miles LLP, the South African Standard bank and Germany's 2nd largest bank Commerzbank, among others. This development not only calls for capacity and institutional building at the NBE to regulate and manage such financial institution at some time in the future but also brings about the issue of the risk of liberalizing the sector and opening the capital account to spotlight.

Given the closed nature of Ethiopia's capital account and the huge financing requirements of the economy, Ethiopia may not afford to restrict capital inflows in to the country by imposing strict capital control regime forever. Thus, the current capital account management regime should be revisited by authorities to loosen some of the restrictions. In revisiting the capital account management regimes there is a need for capital control instruments to be tailored to fit the country's circumstances (see. Ostry *et.al*, 2011). It should also be gradual but with time specific schedule; it should also move from the simple to the complex - for instance, foreign companies being limited to some activities such as management contract or in equity holding with public and domestic private sector – the former having a minority holding to protect the indigenous ownership structure. Given capacity at NBE, another design consideration is the administrative ease of imposing a particular capital control instrument (see Gallagher, 2011; Getnet, 2014).

Finally, from macroeconomic perspective, financial stability is also conditional on prudent policy to address the serious problems of capital flight (that reached over 20 billion in the last two decades (Alemayehu and Addis, 2016), the growing level of external and domestic debt (which is in the course of exceeding the GDP), the alarming levels of trade deficit (which is about -17.5% of the GDP) as well as the consolidated public deficit (which is about -17% of GDP) and its possible monetization and hence inflation and exchange rate depreciation effect (see Alemayehu and Addis, 2015; Alemayehu and Kibrom, 2011). This is important because next to the exposure of CBE and the DBE to unviable or poorly managed public (and semi-public) projects and connected lending and hence a potential systemic risk, macroeconomic instability particularly related to shortage of foreign exchange and inflation is one of the major risk factors for the financial sector stability in Ethiopia (see Alemayehu, 2015).

VI. The speed and sequencing of financial reform

It is generally agreed that macro-economic stability is critical to financial health; cross-country evidence shows that achieving macro-stabilization before or during financial reform controls an important source of financial instability (Demirguc-Kunt and Detragiache 1999: 327). On this score, Ethiopia has done well during the onset of the reform. Despite the Fund's criticism of the pace of financial reform, its July 1999 Article IV consultation with the government commends Ethiopia's '.... remarkable progress in improving macro- economic stability and implementing structural reforms over the last two years, despite the shocks created by heavy terms of trade losses, adverse weather conditions, and the war with Eritrea' (IMF 1999a: 2). Indeed, Ethiopia's macro-economic policymaking is arguably stronger than that of its former cold war patron; Russia's 1998 crisis highlighted the dangerous interaction that can develop between macro-economic instability and the loosely regulated financial system of a transition economy.

Although it is clear that macro-stability must underpin financial reform, the policy debate is far less clear about how far liberalization should go and at what speed. For sure, Ethiopia's policymakers are very aware of the perils of directed credit and interest-rate ceilings; these depressed savings and reduced investment efficiency under the Derg. This experience informed Ethiopia's termination of sector-specific lending rates in 1994 and its decontrol of lending rates in 1998 and thereafter. But how far and how fast financial liberalization should be taken, and what is the optimal sequence of measures (for example early or later privatization) are still issues open to debate, even after a decade and half on this road.

The cross-country evidence in the King and Levine (1993) study indicates that financial liberalization, by fostering financial development, may increase long-run economic growth; this appears to validate the McKinnon-Shaw critique of financial repression. But it is also evident that liberalizing the financial system may increase its fragility. Demirguc-Kunt and Detragiache (1999) and Arestis (2016) find, for example, that banking crises are more common in countries that have liberalized and that the risk is greatest in countries with weak institutions. As Brownbridge and Kirkpatrick (1999: 27) note, the demands on supervisors have grown at a much faster rate than supervisory capacity in many countries; deregulation has allowed the rapid entry of new financial institutions many of which, being small and inexperienced, need close supervision.

It is evident that the World Bank is much more cautious in its advice regarding financial reform than the IMF, and gives more priority to early institutional investment. The Bank's former chief economist, Joseph Stiglitz concludes that '.... the key issue should not be liberalization or deregulation but construction of the regulatory framework that ensures an effective financial sector' (Stiglitz, 1998: 16). Caprio (1996: 1) notes that disappointment with financial reform in Africa and the transition economies might be due to perverse sequencing, in particular '... often more visible aspects of reform, such as complete interest rate deregulation, bank recapitalization, or more recently, the creation of stock exchanges, have been pursued before basic infrastructure in finance—auditing, accounting, legal systems and basic regulations— have been prepared'. Caprio (1996: 4) goes on to argue that although regulatory investment is important, it by no means guarantees safe and sound banking; without motivated bank owners, supervision alone is ineffective. Therefore, reducing competition in private banking may actually improve financial stability (Caprio 1996: 4). Limiting entry raises the value of bank licenses as well as the discounted value of bank profits. This may motivate owners to behave in a safe and sound manner, thereby ensuring that they remain open to enjoy those profits. Hence, limiting entry into banking can support regulatory investments in ensuring the stability of the financial system, at least in transition's early years. In addition, following the Asian financial crisis in late 1990s and the recent global crisis of 2008/09, financial liberalization is not generally recommended by experts or seen cautiously at best (see Arestis, 2016).

In summary, differences with the IMF have arisen over the pace and sequencing of financial reform—not over the desirability of reform per se. There are valid arguments in favour of Ethiopia's cautious approach to financial liberalization, and there are considerable social returns to investment in regulatory capacity. This is demanding of scarce human resources, and this institutional capacity certainly cannot be built overnight in Ethiopia – thus the government's earlier cautious approach was important and the right approach. What is more challenging today, however, is that the government has failed to build such strong capacity over a decade and a half. Hence, the question is how long is the long run? Should Ethiopia need to protect the sector forever? We have returned to this issue in the next and final section.

VII. CONCLUSION

Consideration of financial reform leads to the larger question of what Ethiopia can learn from transition experiences elsewhere. It is now evident that there is no 'one true path' to a market-economy. This much is clear when comparing the diversity of strategies and outcomes among the European and Asian transition countries. Stiglitz (1999) is among many in highlighting the dramatic difference in performance between the FSU and China early on.

China has avoided 'big bang' reform—the rapid privatization and market-decontrol seen in the early years of Russia's transition—in favour of what the Chinese call 'crossing the river by feeling the stones underfoot' (Gros and Steinherr 1995: 109). China reformed agriculture at an early stage and achieved a major expansion in non-traditional exports, but has only later accelerated privatization. Financial reform has been notably cautious and capital account transactions remained restricted. These controls have facilitated the use of monetary policy and the central bank's performance on price stability is greatly superior to that of Russia (Pomfret 1995: 137). Despite financial inefficiency—serious problems in China's state banks are now apparent—growth has nevertheless averaged 9 per cent a year for twenty years and continued to date.[8] China's gradual financial reform is therefore one of the 'highly contradictory ingredients' of its economic transition, a strategy that has nevertheless, delivered unprecedented growth (Gros and Steinherr 1995: 108).

That elements of the former command economy can exist side by side with the new private sector is an anathema to proponents of rapid liberalization. However, this strategy—if well implemented—is not as paradoxical as it first seems given that most policy-makers must live with the market imperfections characteristic of a 'second best' world. For these reasons, Qian (1999: 6) argues that:

> ... the main lesson from Chinese experience is that considerable growth is possible with sensible but not perfect institutions, and that some 'transitional institutions' can be more effective than the best practice institutions for a period of time because of the second-best principle: removing one distortion may be counterproductive in the presence of another distortion.

Hence, Ethiopia's emphasis on maintaining macro-economic stability—even at the cost of retaining inefficiency in the financial system—may be optimal in the second-best world

[8] In part this is because China's private-sector has successfully relied on self-finance (including that provided by the diasporas) rather than bank or state credit (Gros and Steinherr 1995: 111). In this regard, Ethiopia may enjoy an advantage similar to that of China: it is favoured by a large diaspora with excellent financial and commercial linkages. Already remittance has reached USD 3.8 billion in 2015 (larger than the total export of USD 3 billion at the same time). In this regard, it is sad to see the recent NBE rule of excluding the Ethiopian diasporas from the private banking sector when the latter wants to raise their capital most.

that characterises Africa's transition economies. This view is also validated by the official growth rate of Ethiopia which is about 10 per cent per annum consecutively for the last decade. However, we need not to stretch this point too far. Clearly, much depends on how Ethiopia manages the market-controls that it does retain; in particular how the authorities cope with the rent seeking behavior which such controls inevitably encourage. Rent seeking, if unchecked, can pervert otherwise well-intentioned strategies transforming them from mechanisms to raise living standards into means for personal gain. Such, after all, was the experience of Africa's transition economies under state socialism and corruption is becoming an alarming trend in today's Ethiopia. Second, as the Chinese experience shows, a transition economy needs fast growth to tolerate the efficiency losses associated with financial-sector controls (and market-interventions elsewhere). For Ethiopia this means fast and shared growth in general and rural growth in particular—where poverty is deepest— together with a major breakthrough in non-traditional exports which it failed to invigorate thus far - as the stagnation in exports show. This in turn implies close attention to improving micro-finance and rural savings institutions to enable communities to participate in growth is also needed.

To conclude, financial reform raises complex technical issues over which there is at best partial consensus (Jansen 1990, Vos 1993; Arestis, 2016). Since reform began, Ethiopia has seen considerable reorganization of state banks as well as the entry of private banks and insurance companies. Interest rates have been significantly decontrolled and interbank foreign exchange and money markets have been established. Simultaneously, regulatory capacity has been strengthened. Financial reform has been gradual, but nevertheless determined. The government has been very aware of the structural and institutional problems that need to be overcome for a market-based financial system to develop. This has at times provoked disagreement with the IMF, but reform experience in Africa and in the transition economies of Asia and Europe demonstrates that there are many paths through transition, some successful, others not. The creation of a sound financial system is crucial to transition and reconstruction, and to raising the living standards of Ethiopia's people. However, after a decade and half on this path, the challenges of further liberalisation and building the NBE's capacity to regulate and supervise them is becoming more complex and challenging. It is also now obvious that the sector cannot be protected forever at the current level of protection.

In this regard, two policy direction need to be pursued in the immediate future. The first one relates to (i) the issue of deepening the financial sector to enhance domestic resource mobilization. Recent survey based evidence (Wolday and Tekie, 2014) and CBE's saving mobilization performance following its aggressive branch expansion (CBE, Annual Report, 2014) shows that banking those out of reach from banks including through mobile banking, investment and housing loan based saving schemes as well as attractive return on saving are important factors behind saving. Pursuing such policies and closer to a positive real interest rate seems the policy direction to pursue. The second (ii) set of policies relate to a cautiously opening up of the financial sector as it cannot be protected forever, create a level playing field for the public and private financial sectors and time-specific capacity building for supervision and regulation at NBE in a very short time. The latter is important as the NBE's current capacity is weak to handle further liberalization that are getting complex by the day.

Thus, towards that end the NBE needs (a) to have time specific, say a five year, plan to have a highly motivated (including highly paid) high caliber staff to regulate and supervise the sector – this needs to be complemented by continuous training; (b) to work out on partial opening up of the sector through various modalities such as joint venture with local banks having a majority holding, management contract etc and learn from that to build capacity; (c) to worry about the incipient investment banking type of liberalization that is being in the course of developing in the country and noted in this study since it has not developed the capacity to mange and regulated them; and finally (d) it needs to worry about the systemic risks to the CBE and DBE from (i) connected and hence usually poor quality lending, (ii) and form exposure to unviable or poorly managed public and semi-public sector projects. Finally (e), the NBE needs also to worry about financial sector instability that may come from systemic risk related to macroeconomic instability – in particular those related to inflation, and foreign exchange shortage (and hence depreciation and/or foreign exchange rationing). From this angle, since the picture of the Ethiopian financial sector and its macroeconomic environment today are reminiscent of the eve of the 1997 Asian financial crisis (Alemayehu, 2015), it is imperative to study the lessons from that experience and work on preventive measure ahead of time.

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