CHAPTER 1
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1.1 Introduction

Economic development is a phenomenon that is influenced by physical, technological, and social factors. It is not easy to isolate these factors or determine the contribution of any one factor. Moreover, the influence of financial structure particularly forces like financial institutions are too difficult to measure. Nevertheless, the experience of advanced countries as well as developing countries witnesses that financial institutions can act as facilitators or inhibition to economic development depending on the nature of their activities such as mobilization and allocation of resources.

The fact that changes in the structure of aggregate real output and distribution of real income is accompanied by changes in the financial structure is an indication that real development and financial development go together and hence detailed analysis is required in order to understand the financial aspect of economic development.

In the process of rapid and continuous economic development, countries face shortage of finance. The internal as well direct external finance fall short of the increasing fund requirements and the way out of such deadlock is institutionalization of saving and hence indirect finance which is supplied by the financial intermediaries acquires considerable importance.

It is true that to develop an economy in a full-fledged manner financial resources are required. Finance plays crucial role as it places at the command of those who have the technical skill and entrepreneurial talent but lack the means and necessary wherewithal and sinew of development. But it should also be noted that finance is not all in all. The experience of various developing countries witnesses that the availability of finance or abundant savings do not mean the desired and long-awaited rapid growth of the economy is guaranteed.

A few decades ago several economists held the view that development process is constrained by shortage of productive factors of which finance (capital)
was considered as the most strategic one. For instance Harrod (1939), Domar (1947), Nurkse (1947), Lewis (1954), Rostow (1964) held this view. Capital has been held as real basis of economic development, and growth was explained largely in terms of saving ratios and capital output coefficients, as a result of which the estimation of the size of capital investment that would be required for targeted rate of growth was made possible. It was in this manner that Ragnar Nurkse (1953) in his theory of the "vicious circle of poverty" gave much importance to low saving and low investment ratios. Arthur Lewis (1954) also stated that development is possible if a country is transformed from being a 5% saver and investor to a 12% saver and investor.

Others expounded that the functional relationship assumed in models such as Harrod - Domar is inadequate to properly describe the reality in developing countries and if accepted as a proper description of the development process, the model may become a hindrance rather than help in understanding of the reality of the underdeveloped countries.

Myint (1965) and recently Donghyun (1998) stated that a country's rate of economic growth depends not only on how much it can save, but also on how productively it can invest these savings. This seems and to depend on a complex of less easily measurable factors such as skills and attitude of its people, of efficiency and flexibility of its economic organization. Haavelmo (1965) with reference to specific African scenario stated that the value of capital in the growth process was not with the capital per se but rather in conditions enabling the sustained growth of savings in the productive sector at their maximum level of both mobilization and management. Based on the experience of African countries that joined the rank of petroleum producers and exporters, and non-oil exporting countries Adera (1994) and Adedeji (1989) state that, the mechanistic relationship between capital and economic development yield little guidance to the formulation of development policies.

Most of the Sub-Sahara African countries had opportunity of getting money by exporting oil or non-oil products or by borrowing. But they did not use
resources judiciously as a result of which economic growth slowed, stopped or went reverse, though there is hope and promise due to reforms which have started taking place in most of these countries of which Ethiopia is one.

Then what can finance do in and of itself? "There is little that it can do, to assist developing countries particularly the African region to move out of the pit of poverty it had been engulfed in for centuries past (emphasis added)." Thus why Adera (1994) and Bouman (1977) stated that "The mere provision of finance without prior removal of the structural impediments that influence its outcome is using a straw for a battering ram. The gate will not yield, but the straw gets broken." The worst part is that the flow of loan, FDI and donations have become so thin when compared to other developing countries.\(^\text{10}\)

1.2 Financial Structure Matters

The focus is then on the financial structure of a country among others. From early time of Schumpeter, various answers have been given to the question on the effect of financial structure and development on the real sector of the economy. In the past the point of controversy was whether the development of financial institutions matters at all for real growth. The view held varied from considering the development of financial institutions (banks in particular and occasionally including non-monetary financial institutions) as a necessary factor for real growth.

Despite the difference in opinion, a positive effect of financial structure (Financial institutions) of a country in a development process was pointed out by a number of economists, such as Schumpeter\(^\text{11}\), Adelman and Morris, Cameron, Greshenkron, Goldsmith, Mckinnon, Minisky and Patrick to name but a few. For instance the celebrated economist Raymond Goldsmith said:

--- Whether we turn to economic theory or history --- both assure us that the existence and development of a superstructure of financial instruments and institutions is a necessary though not a sufficient condition of economic growth.\(^\text{12}\)
Recently the logic of association between financial development and real growth has received much attention of economists and studies are being carried out to disentangle the complex relationship between financial structure and real economic growth. It is widely accepted that financial structure matters to the development of a country's economy. Sound financial structure moves financial resources from surplus to deficit unit and from activities yielding low social returns to those yielding high social returns. This movement of funds requires appropriate institutions and institutional philosophy; financial instruments that are consistent with savers and borrowers preferences and needs; and a rational structure of positive real interest rates.

More than any other country the nature of the saving behaviour in developing countries necessitate the development of their financial structure. In these countries the three sectors namely the Government, corporate and non-corporate are such that the government sector can not save much and only small amount if there is any, because of the development expenditure of the government on social services such as education, health, social welfare and other infrastructure, which drain the limited pocket of the government.

Neither is the corporate saving large enough in less developed countries. For one thing, the corporate sector itself is small in most LDCs such as Ethiopia. Even in the industrialized countries the corporate sectors saves only a small portion of GDP. It is rather the saving of the non-corporate sector that is of crucial significance in many middle and low-income less developed countries, as it is in the industrialized countries. Thus saving exceeds investment only in the non-corporate sector and the growth of the government and corporate sector whose investment exceed, their savings, depends critically on resource transfer from this sector.

How much of the investment potential will be executed depends on the total level of net saving available to the economy. However, which investment (project) will be executed depends on the mechanism in the country by which savings and investments are brought together. If the matching mechanism is poor one, then
saving will move into sub-optimal avenues, or consumption will be encouraged or may even result in flight of saving in search of better avenues. Hence the importance of the developed financial system which undertakes the role of channeling resource into avenue of best return is obvious.

The absence of a developed financial structure would mean that the so dear domestic saving may not be used so efficiently for the course of economic development since surplus wealth would be hoarded in unproductive forms such as livestock, jewellery, land, and if monetary asset in a form of cash under the mattress, rafter, underground hole etc. The point expounded by Fisk (1975) is very much applicable to such economies:

For a policy point of view, the path to economic development of a society of transitional subsistence production unit lies to a very large extent in increasing the level of participation in the monetary economy, for only with the catalysis of money do the full advantage of specialization, division of labour, and large scale capital formation upon which most economic development depends become accessible. For this reason the response of the subsistence production units to the opportunities and incentives offered by contact with the monetary sector, and the means available for intervention to accelerate and enhance that response, are of particular theoretical and practical interest.

Summing up, the state of financial structure of a country matters a lot. It has substantial impact on the development of a country. Hence it is not innovations in the productive structure, alone which are crucially important for the process of development but also innovations relating to the financial structure. The statement of IFC (1998) that is, "to grow in the next century developing countries will need sound well-regulated financial system that can operate within a challenging climate of change" makes clear that a developed financial structure is so imperative to developing countries.

At time such as this when market is becoming global; the role of the state which used to be dominant in the economy is changing as the private sector takes
the leading role; emphasis is made to transform the largely rural and agriculture dominated economy and the financial sector should not be allowed to continue playing passive role as it used to be in the past in most less developed countries.

1.3 Justification of the Study: The context of Ethiopia

The growth of Ethiopia’s Economy has received more attention and prominence since 1992. The massive investment to transform the subsistence economy and accelerate the pace of development casts financial burden. Adequate financial resource is required to make investment in all sectors of the economy. However, the available evidence shows a widening gap between saving and investment. The flow of foreign resources to the country in the form of development assistance, loan, and FDI are low because the current situation is that financial resources flow to a highly competitive areas. Hence the need to increase savings as a proportion of national income and allocate through efficient resource transfer mechanism is so imperative.

Since 1995 a privatization programme is underway in Ethiopia. The country has embarked upon the privatization of state owned enterprises. The nation’s economy is open for potential foreign and domestic investors. This means competitive financial system is required so that easy access to financial resources could be possible.

As the economy grows the institutions that provide protection to the risk of loss of property, risk of loss of human life value and the risk associated with old age become crucially important. The importance of these institutions is compounded by the important role they play in augmenting to the domestic saving and facilitating investment.

Thus a well developed financial system is absolutely necessary to facilitate the growth of Ethiopia’s Economy. A lot should be done to bring financial intermediaries to full stature. The populace has to be aware of the benefit of the intermediation process. Flexibility, rapidity, transparency of procedures needs to be incorporated in the working of financial institutions more than ever before. In sum,
sound financial institutions are needed for the proper functioning of domestic economy as well as international commerce. Hence study about the role which financial institutions played in the economy is inevitable so us to come up with useful recommendations that would enhance the role of financial institutions in Ethiopia. So this is a study about the financial institutions of Ethiopia in retrospect and prospect.

1.4 Use of the Research Work

This research work is believed to benefit financial institutions, the monetary authorities and the beneficiaries of the services for financial institutions. It is hoped that this study will induce further research with wide coverage and more detailed study about the financial sector in Ethiopia.

1.5 The Specific Objectives

The objectives of this research work are:

I. To study the financial system, particularly the structure and the role of financial intermediaries in the process of Ethiopia’s economic development.

II. To assess the role played by financial institutions in mobilizing savings, lending policies, and innovations made by financial institutions, and to study the awareness of the benefit of financial intermediaries by the people.

III. To study the policies adopted by the government to improve the working of financial institutions, major policy changes and their impact on the working of financial institutions.

IV. To study the scope for financial institutions like mutual funds, private pension funds, merchant banking and the prospect of capital market.

1.6 Hypotheses

The objectives of this research are based on the following hypotheses:
I. Financial intermediaries play crucial role in the mobilization, and allocation of resources into productive avenues and hence have impact on the growth of an economy.

II. Financial intermediaries mobilize more resources when there is awareness on the side of the people about the benefit of financial intermediaries, the income of people grows, and branches are evenly distributed. These factors have in fact limited the mobilization of resources by financial institutions.

III. The efficiency of financial institutions depends on the quality of the competition in the sector, financial liberalization in the absence of competitive market is not efficacious.

IV. Financial intermediaries are the main sources of external fund for various sectors of the economy of which the industrial sector is the main one.

V. The return to the ultimate lenders on the fund and the cost of borrowing to the ultimate borrowers are important factors, which determine the supply of funds and demand for loans.

VI. Financial intermediaries play crucial role in the development of financial market.

1.7 Methodology
1.7.1 The Sources of Data

Data for this research work come from various sources such as:
- Annual and Quarterly publications of the National Bank of Ethiopia
- The publications of Ministry of Economic Development and Cooperation (MEDaC)
- Publications of the Central Statistical Authority (CSA)
- Annual reports of the Commercial Bank of Ethiopia (CBE)
• Annual reports of the Agricultural and Industrial Development Bank (AIDB), now Development Bank of Ethiopia (DBE)

• Condensed statistics of DBE 1970/71-1993/94

• Annual reports of the Construction and Business Bank (CBB) formerly Housing and Saving Bank (HSB)

• Annual reports of Private Banks such as Awash International Bank (AIB), Bank of Abysinia (BOA), Dashen Bank (DB)

• Annual reports of Ethiopian Insurance Corporation (EIC) condensed statistics of Ethiopian Insurance corporation, 1983-1998 compiled at the time of researchers visit of the corporation for data collection

• Fiscal and financial report of Ethiopia, 1974

• The supervisory Authority of Government Enterprises

• Publications of Ethiopian Investment Authority (EIA)

• Various papers presented at conferences of Ethiopian Economic Association (EEA) and Ethiopian Management Professionals Association (EMPA)

• **Publications of International organizations such as:**

• IMF, International Financial Statistics (IFS)

• World Bank, World Development Report

• World Bank Social Indicators of Development

• World Bank, African Development Indicators

• United Nations Industrial Development Organizations (UNIDO)

Besides, knowledgeable and resource persons, working in the financial institutions in Ethiopia, were approached to get more information. To this end interviews of various personalities from public and private financial institutions were held.
1.7.2 About the Data

In Ethiopia MEDaC, NBE and CSA are the main sources of economic and financial data. MEDaC compiles most of the macro economic data whereas the NBE is the main source of financial information of the country. However, data compiled by these authorities are highly aggregated. For instance the saving and investment data does not give details as to how much is saved by the households sector, private industrial and commercial companies, public enterprises, financial institutions and the like. Similarly investment data does not give the break down, of investment made by different sectors.

Apart from this the gross domestic saving is obtained as a residual from the national account identity. The gross fixed capital formation also does not fully cover changes in stock, for instance, due to the private manufacturing and trading business, and investment-in-kind in rural areas though recently an attempt is being made to include such items. The reason is just lack of reliable data on such items. These result in underestimation of investment and then affect the estimation of gross domestic product, which in turn results in underestimation of gross domestic saving. This indicates that there is some measurement error in the GDP figures and its components, for there is no guarantee of perfection of data collection in developing countries.

The publications of NBE (Quarterly and annual reports) also give highly aggregated data. For instance banks deposits by sector such as agricultural sector, non-agricultural and the like; decomposition of private sector deposit into different sectors such as private households, private business and the like are not available.

Similarly the domestic credit data do not give details of credit distribution within the private sector. Also comprehensive historical data on the activities of non-banking financial institution in a compiled form for Public consumption is not available. The alternative is to collect from the annual reports of such institutions. The insurance supervisory department of NBE, recently established, has a database for a few years after 1994.
There is lack of consolidated statement by sector, which shows the sources and uses of funds. Such statement would help to see clearly the position of financial institutions as a source of funds to different sectors such as the public enterprises, private enterprises, households and the like.

In sum in Ethiopia there is a dearth of official comprehensive compiled economic and financial statistics, which facilitates research work. Under such circumstances collecting data becomes the number one most costly task in terms of time and resource. The problem becomes tedious to an individual motivated research work such as this one. In fact difficulty with respect to comparable data in line with clearly defined economic concepts and available for a variety of classifications within a wide group was experienced while this study was made.

Nevertheless, the researcher would like to say that considering limitations, this humble attempt looked at with care and caution would throw some light on the financial sector of Ethiopia.

1.8 Method Used in Data Analysis

Both traditional methods using ratios, growth rates and graphs, and scientific method have been used. Since data confess more when tortured, regression (OLS) analysis was also applied. Multiple regression analysis was used. While making multiple regression analysis tests of multi-collinearity, autocorrelation, heteroscedasticity and normality were made. Tolerance ratio was used to detect multi-collinearity. The test of autocorrelation was done using durbin-watson test statistic. The Jargue-bera (JB) test of normality was applied to test if the residuals are normally distributed or not.

The Prais-Winsten transformation method has been used when problem of autocorrelations was detected. While transforming the original data, the methods suggested by Their and Nagar\textsuperscript{16} was used. The regression analysis is done using Eviews (Econometric views) 2.0.
1.9 The Scope of the Study

This research work mainly focuses on Commercial Bank of Ethiopia, The Development Bank of Ethiopia, and the Ethiopian Insurance Corporation. Other Banking and Non-banking institutions have been considered in this study as the need arose. This is not to undermine the importance of these financial institutions but it is due to natural and inevitable limitations of individual work. This study covers period between 1971-1996. However, journey has been made beyond this period when need felt.

1.10 Scheme of the Chapters

This research work is divided into nine chapters.

Chapter two is devoted to survey of the Ethiopian Economy.

Chapter three sheds light on the Ethiopia's financial sector.

Chapter four reviews literature on some important aspects of the financial system.

Chapter five is devoted to the study of the Deposit money Banks (DMBs) in Ethiopia with special reference to commercial Bank of Ethiopia (CBE).

Chapter six contains study about development banks in Ethiopia.

Chapter seven is devoted to the study of Non-Banking Financial institutions in Ethiopia with special reference to the Ethiopian Insurance Corporation (EIC).

Chapter eight dwells upon the work done in the previous chapters. It evaluates the performance of the Ethiopian financial sector, the role played by banks as a source of investment fund to the large and medium scale manufacturing enterprises, to the small scale and Handicrafts, Micro-enterprises and also examines the role played by financial institutions as a source of funds to the agricultural sector. It also contains an empirical examination of the influence of the financial factors and other variables on the key variables such as saving, investment and economic growth in Ethiopia.
Chapter nine is summary and conclusion, and contains some suggestions to promote future development of financial institutions in Ethiopia.

1.11 Notes and References


3. Hirschman, A.O. (1958), The Strategy of Economic Development, Yale University Press, New Haven. Hirschman’s argument was based on the difference in the scenario in developed and developing countries. That is in developed countries the decision to save and invest is independent while in developing countries the two are interdependent.


8. Ibid, pp. 8–18.


10. For instance because of worldwide liberalization of FDI regimes, inflows of FDI were around US $ 350 billion in 1996. Out of this sum of money the share of developed, developing and African countries was US $ 208, 129 and 5 billion respectively as the investment report 1997 indicates. In 1996 Africa attracted only 1.4% (US $ 5 billion) of the global investment flows while the Asian countries were fairing very well as a preferred investment location. Africa’s share of developing countries in flows was 3.5%. During the same period, Ethiopia’s share was only 0.1% of the total inflows of FDI to African countries. The causes behind differences in foreign direct investment flows among countries are: Political stability, Economic strength, Government policies, Infrastructure are among several others.

11. For instance in the Schumpeterian analysis of capitalist economic development banks, financial institutions or new credit per se, together with availability of entrepreneurs is
considered as primary and essential factor for development. This view was supported by the studies made by Adelman, I and C. Morris (1967) that evaluated the relative impact of 39 socio-economic and political variables on the capacity of 74 developing countries from 1950 - 1963. They found out among all variables, the degree of financial improvement in financial institutions to be statistically most significant and the economic variables with high impact on increasing development. The other important economic variables in their study were physical capital overhead, more rapid expansion of industry and technological advancement of Agriculture. Cit. in Abdi, A.I. (1977). "Commercial Bank and Economic Development: The Experience of Eastern Africa", Prager Publisher.


