CHAPTER - I

INTRODUCTION

1.1 Background of the study

The fundamental question in economic growth that has attracted researchers for long is why countries grow at different rates. The empirical growth literature has come up with numerous explanations of cross-country differences in growth including factor accumulation, resource endowments, the degree of macroeconomic stability, educational attainment, institutional development, legal system effectiveness, international trade, and ethnic and religious diversity. The list of possible factors continues to expand, apparently without limit. One critical factor that has begun to receive considerable attention more recently is the role of financial sector in the growth process.

The link between financial development and economic growth can be traced back to the work of Joseph Schumpeter in the early 20th century, and more recently to McKinnon\(^1\) (1973) and Shaw\(^2\) (1973). Since then a large body of economic literature supports the premise that, in addition to many other important factors, the performance and long-run economic growth and social welfare of a country are related to its degree of financial development. According to Levine\(^3\) (2005), Financial development is measured by factors such as size, depth, access, efficiency and stability of a financial system, which includes its markets, intermediaries, range of assets, institutions, and regulations. The higher the degree of financial development, the wider the availability of financial services that allows the diversification of risks. This increases the long-run growth trajectory of a country and ultimately improves the welfare and prosperity of both producers and consumers.
The banking system is central to a nation’s economy. Banks are special as they not only accept and deploy large amounts of uncollateralized public funds in a fiduciary capacity but also leverage such funds through credit creation. In this regard, Abdulahi (2007) noted that Banks, in their role of financial intermediaries, contribute significantly to the economic activity particularly in developing countries where they represent the main channel of capital flow. The performance of a country’s banking system became a strategic issue to strengthen the resilience of the whole financial system to economic shocks. Moreover, the phenomena of liberalization and deregulation gradually obliged developing countries to engage major structural reforms aiming at improving banks’ efficiency as well as encouraging the competing practices.

Economic theory suggests that financial markets and intermediaries exist mainly because of two types of market frictions - information costs and transaction costs. These frictions lead to the development of financial intermediaries and financial markets, which perform multiple functions. The functions of financial intermediaries include assisting in the trading, hedging, diversification, and pooling of risk; providing insurance services; allocating savings and resources to the appropriate investment projects; monitoring managers and promoting corporate control and governance; mobilizing savings efficiently; and facilitating the exchange of goods and services.

According to Economic outlook (2011), financial intermediation and financial markets contribute directly to increased economic growth and aggregate economic welfare through their effect on capital accumulation (the rate of investment) and on technological innovation. First, greater financial development leads to greater mobilization of savings and its allocation to the highest-return investment projects. This
increased accumulation of capital enhances economic growth. Second, by appropriately allocating capital to the right investment projects and promoting sound corporate governance, financial development increases the rate of technological innovation and productivity growth, further enhancing economic growth and social welfare.

Financial markets and intermediation also benefit consumers and firms in many other ways that are not directly related to economic growth. Access to financial markets not only beneficial to both consumers and producers but also reduces poverty as the poor have access to banking services and credit. The importance of microfinance can be seen in this context. Access to credit allows consumers to smooth consumption over time by borrowing and/or lending; in addition, it stabilizes consumer welfare in the presence of temporary shocks to wages and income. By contributing to the diversification of savings and of portfolio choices, microfinance can also increase the return on savings and ensure higher income and consumption opportunities. Insurance services can help mitigate a variety of risks that individuals and firms face, thus allowing better sharing of individual or even macroeconomic risks (Ibid⁶).

Efficient and healthy financial system is a vital and necessary component for faster economic growth and development. If a financial system is efficient, then it should show profitability improvements, increased funds intermediation, better prices for financial products and quality services for consumers. If the financial system is under tight regulation, financial markets would not function efficiently and the use of resources would not provide desired outcomes. It should also be noted that reforms in other sectors have less impact on the overall economic development if the financial sector is under control (Levine⁷, 1998). Efficient financial intermediation is an important factor in
economic development process as it has implication for effective mobilization of investible resources. Consequently, banking sector efficiency plays significant role in an economy.

It is argued that countries with better/efficient credit systems grow faster while inefficient credit systems bear the risk of bank failure (Kasekende, 2008). Credit institutions intermediate between the surplus and deficit sectors of the economy. Thus, a better functioning credit system alleviates the external financing constraints that impede credit expansion, and the expansion of firms and industries (Mishkin, 2007). Financial intermediaries although regulated, still determine the strategies for allocating funds, and as such they play a significant role in determining the type of investment activities, the level of employment generation, and the distribution of income (Gross, 2001).

However, the relationship between the country’s financial sector and economic growth has been the subject matter of research since the last few decades. Empirical studies on the impact of bank credit on economic growth are scarce. Moreover, the question whether financial development precedes or follows the economic growth has been an extensive subject of empirical research since last few decades. It is widely argued that relatively developed credit market improves the efficiency of resource allocation thereby contributing to higher economic growth of a country. Conversely, a growth push makes credit markets more beneficial to participants, stimulates financial development and strengthens the initial growth effect.

The formal financial system in Ethiopia is dominated mainly by the banking sector. According to World Bank (2007) the banking sector accounts for about 94 per cent of total financial sector assets in Ethiopia, with remaining assets accounted for by
the insurance sector (3 per cent) and microfinance institutions (3 per cent). Banks play an important role of channeling the savings of surplus sectors to deficit sectors. In other words, banks perform an allocative role which is important for the functioning of the economy. The efficiency and competitiveness of banking system defines the strength of any economy. Ethiopian economy is not an exception to this and hence the banking system plays a vital role in the process of economic growth and development of the country. The recent expansion in the number of private banks indicates that commercial banks in Ethiopia have considerable potential for the expansion of short term and medium term industrial finance.

The Ethiopian banking system was ruled by multiple constraints till the end of the 1991. The key regulatory features were interest rate regulation, credit restrictions, equity market controls and foreign exchange controls. Although some restrictions are still in operation, regulations which affect banks are being relaxed with the implementation of financial reforms within the context of structural adjustment proposed by the Bretton Woods institutions. The reforms prioritize the modernization of its financial systems to provide better financial services, and to increase its gross domestic product (GDP) growth rate. The reforms also ought to foster financial development through the reduction of governmental intervention in the financial sectors and participation of private banks in order to promote economic growth through higher mobilization of savings and increase in domestic and foreign investments.

As prescribed by international bodies (IMF/World Bank), the liberalization of the conditions of banking activity have gradually been realized since 1992, and concerned essentially with the deregulation of interest rates, credit allocation, opening up to
participation of private sector banks, and boosting the monetary and equity markets. Consequently, private sector financial institutions are growing rapidly. However, major commercial banks and specialized institutions still remain within the public sector. The liberalization of the financial and banking sectors joined a wider movement of opening the Ethiopian economy to surmount the macroeconomic difficulties and forge ahead in its integration in the world economy. This liberalisation intervened in several considerations, but remained very slow, in consideration of what was realized in other developing countries. This strategic choice of slowness is based on a wise caution which made fault in several countries which knew recent banking crises (IMF\textsuperscript{12}, 1999b). Therefore, realizing the important relationship between banking sector and economic growth this thesis attempts to investigate financial reform and banking sector development, the impact of bank credits on economic growth, and the direction of causality between bank credit and economic growth in Ethiopia.

1.2. Need for the study

The Ethiopian financial system, which is dominated by the banking sector, has gone through several changes in the past two decades. The financial sector was a highly regulated one prior to the outset of structural reforms in 1992. At that time all of the banks were government owned, interest rates completely regulated, a substantial portion of the credit was earmarked for priority sectors, and there was a flourishing unorganized market for credit. Under the Derg regime (1774-75 to 1990-91) all privately owned financial institutions including three commercial banks, thirteen insurance companies and two non-bank financial intermediaries were nationalized on January 1, 1975 (Harvey\textsuperscript{13},
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, 1996b).

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. 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 Commercial Bank of Ethiopia’s (CBE’s) total net deposits averaged 25 per cent during this time (IMF, 1999b).

In recent years, the loan disbursement shows a declining trend in Ethiopia. For instance, bank loan data for the first half of 2009 show that the average private bank has provided only about 177 million Birr in loans over the six month period—equivalent to new loans of just 30 million Birr per month (NBE, 2010). Despite this trend, the government of Ethiopia stressed that the Growth and transformation plan (GTP) to be
implemented in the coming five years (i.e. from 2010-11 to 2014-15) will relay heavily on domestic savings that can be channeled to the main economic sectors through bank credit.

However, little information is available about the activities of the banking industry and how they affect the economy where they operate. Specifically, the impact of bank credit on economic growth and the direction of causality between the two have attracted little attention from researchers in Ethiopia. The position of the country makes it somehow important to see the contribution of the banking sector in stimulating growth within the economy. Hence, the optimism of the government to relay heavily on domestic savings during the GTP motivates us to address questions such as - to what extent bank credit has been supporting in enhancing economic growth thus far, through which channel(s) does bank credit affects economic growth; and what is the direction of causality between bank credit in Ethiopia using multivariate cointegration approach and Granger-causality test. Thus, this thesis attempts to fill such gap and stimulate ideas within this relatively under researched areas using time series data for the period 1971-72 to 2010-11.

1.3. Objectives of the Study

In light of the above facts, the objective of this study is to investigate empirically the impact of bank credit on economic growth in Ethiopia based on the endogenous growth theory. To this end, annual time series data for the period 1971-72 to 2010-11 were used. More specifically, the study attempts:
To examine the trends in financial deepening (measured by the ratio of M2/GDP) and deposit mobilization (measured by the ratio of total deposit/GDP) of the banking sector in Ethiopia during pre-reform and reform periods;

To investigate the change in money liquidity (measured by the ratio of M1/M2) and to identify whether banking habit has been developed in Ethiopia during the reform period;

To compare and contrast the trend and share of the bank credit by borrowers and economic sectors in Ethiopia during pre-reform and reform period;

To examine empirically the long-run and short-run impact of bank credit on economic growth in Ethiopia;

To investigate the transmission mechanism by which bank credit affects economic growth in Ethiopia and

To investigate the direction of causality between bank credit and economic growth in Ethiopia both in the long-run and short-run.

1.4. Research Hypotheses

Based on the specific objectives of the study, the following four research hypotheses are formulated for investigation.

Hypothesis 1: Banking habit in Ethiopia has improved significantly during the reform period (1991-92 to 2010-11)

Hypothesis 2: The share of credit to the private sector to total loans and advances has shown significant improvement during the reform period.
**Hypothesis 3** The long-run and short-run impact of bank credit on economic growth in Ethiopia is positive and statistically significant.

**Hypothesis 4** There is a unidirectional causality between bank credit and long-run economic growth in Ethiopia running from bank credit to economic growth. In other words, bank credit leads economic growth.

### 1.5. Significance of the Study

Recent developments in macroeconomic theory have shown the importance of banks is to the channel idle funds to areas of productive investment and hence financial intermediation influences not only the level of production per worker of a country but its long-run rate of growth. In essence, financial intermediation is a vital function of banks that accounts for a significant share in their operational activities. However, the impact of a nation’s banking system on the productive sector of the economy depends on the development of the country’s overall financial system. In this context, it is worthwhile to study how relevant is the performance of this function to the growth of the economy of a country in line with available theories and evidences in the field.

The significance of this study partly arises from the fact that the formulation of monetary policy aimed at improving the performance of the economy requires an understanding of how domestic bank credit affects economic growth. In the prevailing literature, few researches were conducted in the area of banking system in the Ethiopian context. Most of them focus mainly either on the performance or on the efficiency of Commercial Banks in Ethiopia but failed to show explicitly the channels through which the performances and efficiency of the banks can affect economic growth. These include
among others the study by Alemayehu and Addison\textsuperscript{17} (2003) on financial regulation of Ethiopian Commercial Banks; Kiyota et.al\textsuperscript{18} (2007) study on issues related to financial sector liberalization in Ethiopia, with reference in particular to the Ethiopian banking sector; and Yigremachew’s\textsuperscript{19} (2008) study on the determining factors for the corporate profitability of private commercial banks in Ethiopia.

1.6 The Evolution and Development of Financial Sector in Ethiopia

Banks play important role of channeling the savings of surplus sectors to deficit sectors. The efficiency and competitiveness of banking system defines the strength of any economy. Ethiopian economy is not an exception to this and banking system in Ethiopia also plays a vital role in the process of economic growth and development.

1.6.1. The Structure of Ethiopia's Financial Sector

One of the main objectives of financial institutions is mobilizing resources (in particular domestic saving) and channeling them to investors. This intermediation role of financial institutions takes different forms in different economic systems. Ethiopia’s history of the last four decades clearly shows the validity of this statement. The structure of Ethiopia’s financial sector is reviewed based on the three distinguishable systems of government in the country. These include the Imperial era (prior to 1974); the State Socialism (1974-75 to 1990-91), which is popularly referred in Ethiopia as the ‘Derg1’ Regime; and the reform period (1991-92 to date).

\textsuperscript{1} Derg is an Amharic term meaning “the committee” (of solders)
1.6.1.1. The Imperial era (prior to 1974)

The establishment of the Abyssinian Bank, a private company controlled by the Bank of Egypt, in 1905 marked the beginning 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\textsuperscript{20}, 1990; and Befekadu\textsuperscript{21}, 1995). Further financial institutions were established during the Italian occupations of the late 1930s. During the Italian occupation, currency notes issued by the Bank of Italy formed the legal tender of Ethiopia.

In 1943, the State Bank of Ethiopia was established, with two departments performing separate functions of an issuing bank and a commercial bank, despite considerable British opposition (ibid). Under the subsequent British occupation, Ethiopia was briefly a part of the East Africa Currency Board. The State Bank of Ethiopia operated both as a commercial and central bank until 1963. In 1963, these functions were formally separated and the National Bank of Ethiopia (the central and issuing bank) and the Commercial Bank of Ethiopia (CBE) were formed.

Prior to the emergence of the Marxist government, Ethiopia had several state-owned banking institutions and private financial institutions established during the 1960s. The National Bank of Ethiopia (the country's central bank and financial adviser), the Commercial Bank of Ethiopia (which handled commercial operations), the Agricultural and Industrial Development Bank (established largely to finance state-owned enterprises), the Savings and Mortgage Corporation of Ethiopia, and the Imperial Savings and Home Ownership Public Association (which provided savings and loan services)
were the major state-owned banks. Major private commercial institutions, many of which were foreign owned, included the Addis Ababa Bank, the Banco di Napoli, and the Banco di Roma. In addition, there were several insurance companies. Therefore, 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.

1.6.1.2. The Derg era (1974-75 to 1990-91)

The 1974 revolution and the subsequent shift to Marxist government brought several major changes to the banking system. In January and February 1975, the government nationalized and subsequently reorganized private banks and insurance companies as state financial institutions. By the early 1980s, the country's banking system included the National Bank of Ethiopia; the Addis Ababa Bank, which was formed by merging the three commercial banks that existed prior to the revolution; the Ethiopian Insurance Corporation, which incorporated all of the nationalized insurance companies; and the new Housing and Savings Bank, which was responsible for making loans for new housing and home improvement. The government placed all banks and financial institutions under the National Bank of Ethiopia's control and supervision (NBE, 1996a).

The National Bank of Ethiopia regulated currency, controlled credit and monetary policy, and administered foreign-currency transactions including the official foreign-exchange reserves. A majority of the banking services were concentrated in major urban areas, although there were efforts to establish more rural bank branches throughout the
country. However, the lending strategies of the banks showed that the productive sectors were not given priority. In 1988, for example, about 55 percent of all commercial bank credit financed imports and domestic trade and services. Agriculture and industry received only 6 and 13 percent of the commercial credit, respectively.

Successful reconstruction and development of financial institutions require efficient mobilisation of resources, in particular domestic savings, and channelling 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 (1974-75 to 1990-91), Ethiopia's financial institutions were charged with executing the national economic plan; state enterprises received bank finance in accordance with the plan's priorities. The command economic 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.

In this period, the NBE was actively involved in direct controlling of all financial institutions by (a) fixing both deposit and lending interest rates, (b) directly controlling the foreign exchange and credit allocation which was done in a discriminatory manner, by favoring the public sector, and (c) by directly financing government deficit (NBE23, 1998). Bank supervision/regulation has been largely limited to on and off inspection on a few branches. The Derg regime is also characterized by an economic policy largely informed by the ideology of ‘socialism’. The importance of such set-up is the prominent role accorded to the socialized sectors by discriminating against the private sector. During the Derg time indirect ways of regulating the financial sector was not important
since it can be controlled directly. The most important financial instruments used to directly control the sector were interest rate, discriminatory allocation of foreign exchange, and credit (Alemayehu, 2006).

Accordingly, bank credit allocation was guided by socialist ideological considerations during the Derg period. In consultation with the Ministry of Finance and the Planning Ministry, the NBE projects the financial planning of the economy. It identifies the financial needs of different sectors through surveys and data obtained from credit institutions. Based on such information it determines the distribution of credit favoring priority investments and aiming at keeping internal and external purchasing power of the national currency unaltered. In credit allocation financial institutions used credit policy as a factor of strengthening and expanding the socialized sector and encouraging the socialization of others. This favoring of the socialized sector is shown by the fact that a good part of the banks resources were directed to the socialized sector (for instance 68 per cent of ADB resources were allocated to State farms) and that the state farms and cooperatives were not required collateral when granted loans (Di Antonio, 1988: 71-72). As noted by Di Antonio, this restrictive policy has resulted in excess liquidity in the banking sectors in the 1980 chiefly because of (a) the biased credit policy, (b) the collateral requirement on the private sector, (c) seasonal trends and the (then) existing economic condition as well as (d) the CBE’s inefficiency.

1.6.1.3. Reform period (1991-92 to date)

Following the demise of the Derg regime in 1991, post-1991 economic policy witnessed a departure from command economic system. Its main difference lies on openly adopting a market-oriented economic policy. In fact much of the policies adopted
by the new government in 1991 had been already proposed by the defunct Derg regime virtually at the end of its reign. This new change in policy brought about a significant change in the functioning of the financial sector. Not only is the financial sector is going to serve the private sector, which hitherto had been demonized, but also new private financial institutions were emerging. Equally the role of the Ethiopia’s central bank (named National Bank of Ethiopia, NBE henceforth) was also reformulated. Thus, financial sector reconstruction was the top item in the government’s agenda (Alemayehu and Addison\textsuperscript{26}, 2003)

In undertaking this task the Ethiopian government adopted a strategy of (a) gradualism: gradual opening up of private banks and insurance companies alongside the public ones, gradual liberalization of the foreign exchange market etc and (b) strengthening domestic competitive capacity before full liberalization (i.e., restrict the sector to domestic investors, strengthening the regulatory and supervision capacity of the NBE, providing autonomy to banks as well as opening up inter-bank money market etc). In line with this strategy various proclamations and regulations were passed since 1992 (Ibid\textsuperscript{27}).

This transition to a market economy 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 was being reformulated. The National Bank of Ethiopia (NBE) periodically makes available to the public several statistical publications on macroeconomic factors in Ethiopia. The inter-bank money market is weak and few banks access the re-discount window. According to
the NBE website (www.nbe.gov.et/), the functions of the National Bank of Ethiopia are as follows:

- Mints Coins, print and issues the legal tender currency, and regulates the country's money supply,
- Regulates the applicable interest rate and other cost of money charges,
- Formulates, implements, and follows-up the country's exchange rate policy, and manages and administers the international reserves of the country,
- Licenses, supervises and regulates the operations of banks, insurance companies and other financial institutions,
- Sets limits on gold and foreign exchange assets, which banks, and other financial institutions authorized to deal in foreign exchange and hold in deposits,
- Sets limits on the net foreign exchange positions and terms, and the amount of external indebtedness of banks and other financial institutions,
- Provides short and long term refinancing facilities to banks and other financial institutions,
- Accepts deposit of any kind from foreign sources,
- Promotes and encourages the dissemination of banking and insurance services throughout the country,
- Prepares periodic economic studies, together with forecasts of the balance of payments, money supply, prices and other relevant statistical indicators of the Ethiopian economy useful for analysis and for the formulation and determination by the Bank of monetary, saving and exchange policies,
- Acts as banker, fiscal agent and financial advisor to the Government,
Represents the country in international monetary institutions and acts consistently with international monetary and banking agreements to which Ethiopia is a party, and

Exercises and performs such other powers and activities as central banks customarily perform.

The National Bank of Ethiopia has a monopoly on all foreign exchange transactions and supervises all foreign exchange payments and remittances. The Ethiopian currency - Birr, is not convertible. The government carefully monitors and controls its movement and as a result, it trades in a very narrow range. Birr is widely considered to be overvalued particularly in light of Ethiopia’s high inflation rate.

1.6.2. Financial sector development in Ethiopia

With the fall of the Derg in 1991, the new government faced the difficult tasks of organizing the demobilisation as well as starting the transition to a market economy. Economic reform began soon after the new government took power. Derg's policies had left a crippled economy and impoverished people. Fiscal policy aimed to raise revenue and to reduce the fiscal deficit, which is 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
(Aron²⁹, 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 1993-1996. 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.

Later on the financial liberalization allowed the participation of private financial institutions in the economy. At the end of 2011, the Ethiopian banking sector comprises one development bank (DBE), two state-owned commercial banks, namely, Commercial Bank of Ethiopia (CBE) and Construction and Business Bank (CBB), and twelve private commercial banks. Private Banks’ participation has increased gradually and hence the share of their banking assets to total commercial banking assets (NBE³⁰, 2011).

Thus, the government's strategy for financial development is characterized by gradualism—the financial sector currently consists 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 Sousa³¹, 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.
Private Banks have been notable for their relative dynamism, better services, and reliance on private sector clients. The introduction and expansion of private banks in the past decade has coincided with improved banking services, including such features as longer banking hours, ATMs, electronic banking, and improved facilities. This reflects the liberalization of business licensing which encouraged private-sector growth. The objectives was to bring changes on the supply-side of the loan market paralleled by important changes on the demand side the main indicators being changes in the share of private-sector credit to total domestic credit and CBE's credits to the public-sector. However, it can be inferred that the financial system of Ethiopia is very underdeveloped. There is no stock exchange and of the eleven banks that exist in the country, three are state owned and dominate the sector. There are no foreign banks in the country, and the system remains isolated from the effects of globalization while policy-makers fear that liberalization will lead to loss of control over the economy. The government controls interest rates and sets them below the high inflation rate (Alemayehu and Addison, 2003).

1.6.3. 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, and Stiglitz, 1994). In Ethiopia this imperfection is aggravated by the institutional under-investment of the Derg era. Public and private banks are only now 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, as in Africa's and other transition economies.

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. Hence, the NBE understood the need for skills of prudential regulation and supervision appropriate to a market-based financial system. 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 (Polizatto, 1993).

In 1996, the NBE established a new division to undertake regulation and supervision. Its 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 late 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 regulations. This also encourages banks to seek out new customers, an incentive that is important to raising private sector investment and thereby achieving reconstruction.

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. Hence Banks are required to report their weekly liquidity position to NBE as a further safeguard to protect depositors. The NBE has comprehensive on-site examination powers under which banks are subject to annual inspection, and can be visited at any time without notice. Moreover, the valuation of bank assets has not been a straightforward process (GOE-IMF, 1998).

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 was retained at 6 per cent to ensure 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.

However, the floor can be removed when excess liquidity is finally eliminated. With a stronger banking system and an improving macroeconomic situation, further
institutional investment could take place. For example, an inter-bank 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 inter-bank 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 reserve positions with NBE. The inter-bank market will facilitate indirect instruments of monetary policy (such as open market operations using government paper) to influence liquidity and interest rates (Allemayehu\textsuperscript{38}, 2006).

In Africa two problems hamper the creation of modern, market-based, financial system. 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\textsuperscript{39}, 1994). Secondly, inter-bank transactions are uninsured, thereby creating a systemic risk. Indeed, inter-bank credit experiences in Ethiopia highlight the above facts. Public 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\textsuperscript{40}, 1998). 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 inter-bank market spread financial distress throughout the system.
1.6.3.1. IMF criticism of the financial sector

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 Enhanced Structural Adjustment Facility (ESAF) in October 1997. IMF criticism focused on two major issues. First, the IMF argued that CBE's share of the deposit and loan markets 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\textsuperscript{41} 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. 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—the second largest commercial bank—but remains wary of privatizing CBE. IMF also cites the improvement in CBE's performance since the NBE supervision and the erosion of CBE's dominance in the loan market.

However, experience elsewhere indicates that privatization does not automatically improve performance; the 1998 scandal involving the Uganda Commercial Bank is a case in point. This leads Roe et. al\textsuperscript{42} (1998) 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.

1.6.3.2. The speed and sequencing of financial reform

It is generally agreed that macro-economic stability is critical to financial health of a country. However, cross country evidence shows that achieving macro-stabilization before or during financial reform controls an important source of financial instability (Demirguc-Kunt and Detragiache\textsuperscript{43}, 1999: 327). Though, IMF criticised the pace of financial reform, its July 1999 Article IV consultation with the government commends that Ethiopia's “.... remarkable progress in improving macroeconomic stability and implementing structural reforms in 1997 and 1998, despite the shocks created by heavy terms of trade losses, adverse weather conditions, and the war with Eritrea” (IMF\textsuperscript{44}, 1999a: 2).

Although it is clear that macro-stability must underpin financial reform, the policy debate is far less clear about how far liberalization should go. For sure, Ethiopia's policymakers are very aware of the perils of directed credit and interest-rate ceilings, which depressed savings and reduced investment efficiency under the Derg. This experience led to Ethiopia's termination of sector-specific lending rates in 1994 and its decontrol of lending rates in 1998. 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.
The cross-country evidence in the King and Levine\textsuperscript{45} (1993a) 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 now evident that liberalizing the financial system may increase its fragility. Demirguc-Kunt and Detragiache\textsuperscript{46} (1999) 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\textsuperscript{47} (2000) observed, 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 now 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\textsuperscript{48}, 1998: 16).

Caprio\textsuperscript{49} (1996: 1) noted 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’. He goes on arguing 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. 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.

1.7. Scope of the Study

The main aim of this thesis is to examine the impact of bank credit on economic growth in Ethiopia identifying the channel through which bank credit affects economic growth. Thus, it focuses on empirically the development of the banking system and whether bank credit transforms the long-run and short-run economic growth of Ethiopia or not. In the regression analysis, the proxy for bank credit is bank credit disbursed by all commercial banks and the Development Bank of Ethiopia to the private sector. It does not include credit to the central government by the National bank of Ethiopia (NBE). Other financial systems are beyond the reach or scope of this thesis.

To achieve the objectives of the thesis secondary data spanning for the period 1971-72 to 2010-11 are used. The reason behind choosing this span of time is to include a sample of 20 years observation covering pre-reform and reform periods. The methodology employed in this study include descriptive statistics, ratio analysis technique and two distinct endogenous growth accounting econometric techniques namely multivariate Johansson Cointegration approach and bivariate Granger causality
test. In econometric models log-linear models are used in the sense the models reflect the elasticity of the dependent variables to a change in the explanatory variables.

### 1.8. Limitations of the Study

One of the major limitations of the study is availability and inconsistency of data in different sources. First, this study would have been best if it uses quarterly for the pre-reform and reform period so as to understand clearly how credit to the private sector during the financial repression during the command economy between 1974-75 and 1990-91 and the market economy period credit since 1991-92 affects economic growth. But quarterly data for most of the variables included in the multivariate VAR models such as GDP (both real and nominal), gross domestic investment, government consumption, CPI, and gross secondary school enrollment are not available. Moreover, data on work force is not available, which forces us to proxy it with labour force.

This study also fails to provide clear picture on financial inclusiveness by analyzing population per branch for the time period covered in the study and distribution of banks throughout the country. Nevertheless, what NBE annual reports provide is that the number of banks in the capital city (Addis Ababa) and in the regional states. The data for regional states is not disaggregated into the nine regions and Dire Dawa chartered city.

A major indicator of banking sector efficiency is interest rate spreads in pre-reform and reform period. The study did not consider this important variable due to unavailability of data on real interest rate prior to 1985. Analysing this variable could add to the substance of the study for it is the major indicator of success in financial liberalization. Moreover, the study fails to model modeling foreign capital along with
domestic capital and examine how the inclusion of foreign capital into the regression of growth model and domestic capital model affects the impact of bank credit on economic growth. However, data of foreign direct investment for the period 1977-78 to 1991-92 is zero, which poses problem in regression.

1.9. Organization of the study

The rest of the thesis is organized as follows. Chapter two reviews the related theoretical and empirical literature. Chapter three discusses in depth the data and methodology of the study. Chapter four provides the profile of Ethiopia. In chapter five the development of the banking system in Ethiopia is analysed using descriptive statistics and mean difference analysis technique. Chapter six presents the results and discussion on the impact of bank credit on economic growth in Ethiopia both in the long-run and short-run while chapter seven examines the direction of causality between bank credit and economic growth in Ethiopia. Finally, chapter eight concludes the study by providing the summary and conclusions of the study as well as articulating future areas of research.
References


6. Ibid


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28 National bank of Ethiopia (NBE) website: www.nbe.gov.et


30 NBE (2011), National Bank of Ethiopia Annual Performance Report, 4\textsuperscript{th} quarter


