Preface

The role of banks in any economic development cannot be overemphasized. Banks serve as an important channel for economic growth through mobilizing financial savings from within and outside a country, allocating the financial resources to the most productive use by transforming different risks. Needless to say, banks play key roles in expanding and enhancing trade, commerce and industry. Efficient and profitable banks maximize shareholders' value and encourage the shareholders to make additional investments. As a result of which, more employment opportunities will be created and more goods and service will be produced and ultimately bring about economic growth. Banks are crucial for any country's economy particularly that of the economy of the developing countries such as Ethiopia, because no growth can be achieved if savings are not efficiently channeled into productive investment opportunities. Thus, the health of the banking sector determines the health of the other sectors in an economy.

This study, therefore, measures the efficiency of commercial banks in Ethiopia and examines the factors that influence the financial performance of the banks over the period 1999-00 to 2010-11. The linear programming model, Data Envelopment Analysis, has been used to estimate the efficiency of the banks. The study has used the fixed effects model so as to identify the determinants of the financial performance, measured by Return on Average Assets, of the banks. The result of the study reveals that the banks could have efficiency gains from better cost control. Wastage of resources and inappropriate scale of bank operations are found to be the causes of overall technical inefficiency of the banks. The study finds that most

of the banks are excessively small for scale of their operation and are operating at sub-optimal scale size. Further, the study finds higher levels of inefficiency for the banks on the cost side than on the profit side. In terms of ownership, the study finds the state owned banks to be better off than the private banks in terms of managerial efficiency, scale efficiency and profit efficiency. On the other hand, the study finds the private banks to be better off than the state owned banks in terms of cost efficiency and allocative efficiency. As far as the determinants of bank performance is concerned, the study finds a strong and positive association between ROAA and capital adequacy, diversification, bank size, market concentration, and real GDP growth rate. Liquidity and operational efficiency are found to have a negative and statistically significant impact on the profitability of the banks. Credit risk, market share and inflation are found to have less effect on the performance of the banks.