BANKING REFORM IN ETHIOPIA

Charles Harvey

Summary

The monopoly government-owned banks in Ethiopia remained relatively sound throughout the period of socialist government. This was because:

- the parastatal sector, to which the banking sector was forced to lend, remained profitable and;

- branch expansion was steady rather than reckless. Partly as a result, there was considerable financial deepening, helped by real interest rates not being continuously negative, and by public confidence in the banking system not being threatened.

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

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

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

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

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1. Introduction

In most African countries[2] at the time of independence, there was no central bank and banking was dominated by foreign-owned commercial banks. After independence, new governments embarked on financial sector reform. This took a variety of forms, but the fundamental objective was increased lending to Africans and African-owned businesses, to correct the perceived bias of bank lending in the colonial period [Harvey, 1991].

In Ethiopia, there was a major change of economic strategy in 1975, after the fall of the imperial government, which was in some ways analogous to the changes in economic policy after independence in former colonies. Nevertheless, government policy on banking in Ethiopia does not really fit these generalisations.[3] Most notably, Ethiopia was not a colony; there was already a central bank in 1975; and at that time, most of the rest of the financial sector was already government-owned. The new Ethiopian government aimed to create a socialist, centrally controlled economy on the Soviet model. The main financial sector reform, therefore, was to direct the government banks to finance a greatly increased public sector.

The consequences of the post-1975 reforms in Ethiopia were also distinctive. Government ownership, and government direction of lending, might have been expected to undermine the banks, as happened elsewhere in Africa. Unusually, the damage was limited. Most notably, the single commercial bank remained sound. It did not require lengthy and costly rehabilitation, therefore, in order to be able to respond to the opportunities created by economic liberalisation in the 1990s. This was not sufficient, however, for financial sector reform to achieve its objectives. Government-owned development banks expanded into commercial banking, but increased competition, and the increased productivity and improved services which should result from competition, appeared unlikely to result. A small amount of competition was possible from the licencing of new private sector commercial banks, but their success was endangered by inadequate banking legislation and central bank supervisory capacity. Moreover,

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[1] The author would like to thank Martin Brownbridge for extensive and detailed comments on an earlier draft, and Janine Aron for generously sharing information gathered while doing research in 1996 for a related project.

[2] Anglophone Africa; this research project does not cover Francophone or lusophone Africa.

[3] This paper considers only formal sector financial institutions. For the informal financial sector, see for example Dejene Aredo (1993).

expertise in both the large and small banks appeared to be inadequate for the rapid increase in sound lending to the private sector that was occurring. These factors exposed the banking system to some degree of risk.

The early history of banking in Ethiopia, with its distinctive mixture of foreign and government financial institutions, is briefly described in section 2. The unexpectedly limited impact of the post-1975 policy changes on the quality of bank lending and management, and therefore solvency, is analysed in section 3. Financial sector liberalisation is too recent for its impact to be fully assessed, but the immediate changes and their likely consequences are discussed in section 4. It is difficult to draw conclusions at this stage, but section 5 discusses the risk of financial institutions being unable to manage the changes successfully, on the one hand, and the probability on the other hand that serious problems will be avoided because of the cautious way in which the Ethiopian authorities introduced financial sector reforms (in both the late 1970s and the 1990s) and the record of cautious bank management.

2. The pre-socialist period

The first bank to be established in Ethiopia was the Bank of Abyssinia in 1905.[4] It was owned and managed by the British-owned National Bank of Egypt. It was given a banking monopoly for fifty years, including the right to issue notes and coins. However, three other banks were established in the next ten years. In 1931, the Bank of Abyssinia was replaced by the Bank of Ethiopia which was wholly owned by the government and members of the Ethiopian aristocracy, becoming the first 100% African-owned bank on the continent; it was also authorised to issue notes and coins and to act as the government's bank. It operated for only a few years, being closed after the Italian invasion. During the Italian occupation, several Italian banks opened branches in Ethiopia.

After the liberation in 1942, the State Bank of Ethiopia was established. It became operational in 1943, with 43 employees and two branches, and acted as the country's central bank. The first governor was a Canadian. The Bank also acted as the country's main commercial bank, while a few much smaller foreign banks continued to operate. The country's first development bank was founded in 1951: the World Bank provided $2 million towards the founding of the Development Bank of Ethiopia, and invested a further $2 million in 1960.

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[4] This section draws on Belai Giday [1987] and Hamza Abdurezak [1988].

In 1963, a new banking law split the functions of the State Bank of Ethiopia into central and commercial banking as the National Bank of Ethiopia and the Commercial Bank of Ethiopia respectively. Both were government-owned. The 1963 banking law allowed for other commercial banks to operate. This included foreign banks provided they were 51% owned by Ethiopians. The biggest of these was the Addis Ababa Bank. It was 40% owned by Grindlays Bank (British owned) and had 26 branches by 1975. There were also two foreign commercial banks: the Banco di Roma and the Banco di Napoli, which had eight branches and one branch respectively in 1975.

In addition to the commercial banks, the government established two development banks, both of which were 100% state owned. The Agricultural and Industrial Development Bank (AIDB) was set up in 1970, taking over two earlier development banks: the Development Bank of Ethiopia and the Ethiopian Investment Corporation which had been established in 1963 as the Investment Bank of Ethiopia. AIDB was 100% government-owned, and provided short, medium and long term loans to the agricultural and industrial sectors.[5] The Housing and Savings Bank was created in 1975 out of a merger between two earlier housing finance institutions created in 1962 and 1965, one of them with a grant from the United States government.[6]

3. The socialist period

3.1 Objectives of economic policy

The fall of the imperial government in 1974 led to a major change in economic policy. The new military government declared Ethiopia to be a socialist state, although the army soon disagreed with socialist intellectuals, who were killed or driven into exile. The government steadily extended its control over the whole economy, with Soviet support. The nationalisation of all large corporations was one of the instruments for establishing this centralised control.

As far as ownership of financial institutions was concerned, this made little difference, since the remaining private sector commercial banks were relatively small; they were nationalised and concentrated into the Commercial Bank of Ethiopia (CBE). The new Ethiopian government merely shifted, therefore, from owning most of the banking system to owning it completely.

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5 Its name was changed to the Development Bank of Ethiopia in 1994.

6 The Housing and Savings Bank became the Construction and Business Bank in 1994.

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

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

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

The CBE was an exception to this generalisation. There were a number of reasons. First, and probably most fundamentally, during most of the socialist period, the majority of public enterprises made a profit and were therefore able to service their debts [Eshetu Chole, 1994]. To a considerable extent, the ability of public enterprises to service their loans was assured by their receiving sufficient allocations of scarce foreign exchange to remain viable. The profitability of public enterprises was sharply reduced during the civil war. From 1989, they suffered from reduced capacity utilisation because of worsened foreign exchange shortages, made losses, and did not pay debt service. However, this problem lasted for only one or two years. Public enterprises then returned to profitability because foreign exchange became more readily available. Lending to the private sector (varying between 30 and 40% of loans and advances between 1981 and 1993) was equally straightforward: without foreign exchange, potential borrowers were not creditworthy, with foreign exchange allocations they were virtually guaranteed to be profitable.[7]

The CBE made no provisions against lending to public enterprises during the relatively short period while debt service was in arrears (with the exception of lending to the

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[7] CBE was not reportedly under pressure to lend to private sector borrowers on political grounds. The government used other methods to maintain political support.

construction sector, for which provisions were made after 1990). In practice, the CBE clearly expected the government to carry any unrecovered losses eventually. The losses incurred from lending to the construction sector have been "presented" to government, and government is expected to issue bonds in their place. There was therefore a second line of defence in the CBE's lending to parastatals, namely that the bank expected to be compensated for the cost of any bad debts resulting from lending it had been instructed to do. There are examples of banks continuing to lend on the basis of government guarantees which clearly could not be honoured, and which both parties knew could not be honoured [White 1993], but Ethiopia does not appear to have been in this situation.

There is a certain logic in such procedures, in that the banks, all government-owned, were part of the public sector. As a consequence, the allocation of expenses, such as parastatal inability to pay debt service, was to some extent a matter of accounting procedures. Bank deposits were considered as an additional resource to finance public sector activities, with the possibility of later repayment; the government-owned commercial bank was simply a convenient transmission mechanism, rather than a source of independent decision-making on the allocation of resources. In such a situation, it was not in the government's interest to undermine the functioning of the bank if the "borrowers" were unable to repay.

Most unusually in these circumstances, the CBE continued to do credit analysis of lending decisions according to the commercial criteria used in the pre-socialist period, and continued to train its staff in the necessary techniques, even though the majority of lending was to public enterprises and the bank was not able to refuse government instructions to lend where that analysis was negative. The management of commercial banking was therefore apparently a rather unusual mixture of continued attention to commercial criteria, combined with submission to the demands of central planning in making loans to public enterprises. This had important consequences. Some technical capacity to make loans using commercial criteria was retained, enhanced by the continuity of employment in the management cadre of those with pre-1975 experience.

A second factor was that although the CBE was under pressure from the government to expand its branch network, the expansion which took place was not so rapid, apparently, as to endanger the efficiency and therefore the profitability of the bank. Table 1 below shows a fairly steady branch expansion, which contrasts strongly with the sort of reckless branch expansion which overstretched management capacity and contributed substantially to institutional decay in the Uganda Commercial Bank in the late 1980s, for example.

Table 1

Commercial Bank of Ethiopia: opening of new branches and branch offices

Year	Branches opened	Year	Branches opened	Year	Branches opened
1975	2	1982	5	1989	3
1976	2	1983	4	1990	0
1977	5	1984	4	1991	0
1978	6	1985	3	1992	4
1979	6	1986	2	1993	1
1980	11	1987	6	1994	3
1981	3	1988	1	*Total*	71

Source: Commercial Bank of Ethiopia Statistical Review, June 1994

Third, the spread between deposit and lending rates, as determined by the central bank, remained adequate to give CBE comfortable profits. An important factor in banking margins was that non-interest bearing demand deposits were always between 50 and 60% of total deposits, and the cost of servicing demand deposits was held down by the CBE not opening accounts for individuals. Put slightly differently, the profitability of CBE was underwritten by the large demand deposits of public enterprises and the central government, which together accounted for approximately 50% of all CBE's demand deposits. The only exception to comfortable profits was in the early 1990s, when a change in interest rates sharply reduced gross lending margins; apart from this short period, the return on assets never fell much below 2%, and the return on capital only fell below 100% in 1991.[8]

Fourth, it would have been possible for bad debts to have rendered CBE insolvent, whatever the spreads available. On the published evidence, this did not happen. The bank always provisioned for doubtful debts, with the ratio of annual provisions to loans outstanding varying between 0.9% and 2.8%. This degree of variation suggests that something better than a mechanical formula was being applied. Cumulative provisions were much larger, varying between 14 and 27% of total lending, because bad debts actually written off were always a very small proportion of provisions:10% from 1981 to 1983, and from 1 to 5% thereafter. Either the writing off of bad debts was inadequate, or

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[8] According to its own published accounts, see remarks below on the standards of the government Audit Services Corporation. Given that loans fell to only 16% of assets by 1990, and that the return on Treasury Bills and long term government bonds combined was only about 4.4%, interest margins alone did not provide a 2% net return on assets; however, commissions (on letters of credit, etc.) and other income (mainly from foreign exchange dealing) added some 50% to interest income [Commercial Bank of Ethiopia, Annual Reports].

unnecessary provisions amounted to a hidden reserve. In 1994, reserves were B224 million compared with cumulative provisions of B467 million. Writing back most of the cumulative total of provisions into capital, under the assumption that actual bad debts really are indeed less than five per cent of provisions, would more than triple the bank's reserves. It is also possible that the CBE chose to make excessive provisions because the government was taking 100% of profits (net of provisions for doubtful debts) in taxation and dividends (see below).

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

Fifth, it should be noted that the risk of lending to parastatals was somewhat reduced because because deposits of public enterprises were very roughly as large as, and frequently larger than, loans outstanding. Collectively, therefore, public enterprises did not threaten the solvency of the CBE.[9]

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

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

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[9] Of course, individual public enterprises with deposits greater than bank borrowings would not necessarily cover the defaults of other public enterprises.

As a consequence of these factors, the ratio of CBE's capital and reserves to loans outstanding remained comfortably above 9%, averaging 10.7% in the period 1981-92 (see Table 1). The ratio of capital and reserves to all risk assets (loans plus liabilities on Letters of Credit) was slightly lower, averaging 7.3%. These ratios were respectable, even though they were relatively unnecessary given that most lending was to state-owned enterprises with their implicit guarantees and matching demand deposits. Capital ratios remained adequate despite reserves being constant in nominal terms from 1983 right through until 1992. This was because lending was also stagnant in nominal terms, remaining (after some upward fluctuations) below its 1981 level until 1992. It did not matter, therefore, that the bank was not permitted to retain any of its profit for addition to reserves. It paid half its profits in tax, and the other half as a dividend to the government.

Table 2

Commercial Bank of Ethiopia: ratio of capital and reserves to risk assets

Year	Capital	Capital/ loans	Cap'l/(loans + L of Cs)
	B mn	(%)	%)
1981	81	9.3	6.6
1982	89	9.7	6.8
1983	100	11.5	8.3
1984	104	12.6	8.7
1985	104	13.7	9.7
1986	104	13.9	7.8
1987	106	12.1	7.5
1988	106	9.6	6.3
1989	106	10.2	6.9
1990	105	11.2	8.1
1991	104	12.4	9.1
1992	104	10.6	7.8
1993	104	4.7	3.1
1994	224	7.9	5.6
Average		10.7	7.3

Source: Commercial Bank of Ethiopia Annual Reports

When lending increased in 1993, by more than 100%, the capital adequacy ratio fell to 3%; in 1994, reserves were more than doubled, raising the capital ratio to 5.6% (see Table 2). This partial restoration of capital adequacy was made possible by allowing the bank to retain some of its post-tax profits. The return of property nationalised after the fall of the imperial government also added to the bank's capital.

The institutional soundness of the CBE was sustained, therefore, by a steady reduction in the proportion of loans and advances in its assets, by the high proportion of loans to (solvent) public enterprises which also carried an implicit government guarantee, by apparently adequate provisions for bad debts, by the maintenance of reasonable (if not generous) capital ratios, and by its remaining profitable. Although profits were all paid to the government, there was the potential for their being used to augment capital reserves, as was done in 1994. This comfortable position could of course be undermined by changing circumstances, for example if public enterprises were to become unprofitable as a result of economic liberalisation and were to have government guarantees of their debts withdrawn, or if the shift to lending more to the private sector were to result in sharply increased bad debts. Moreover, it is not possible to be absolutely certain that bad debts were not being concealed while bank supervision was weak and audit was by another government institution.

3.3 Impact on financial institutions: the AIDB and the HSB

To a limited extent, the existence of other government-owned financial institutions protected the Commercial Bank of Ethiopia from government pressure to lend in ways that would have created large-scale bad debts. The Agricultural and Industrial Development Bank (AIDB) was obliged to provide both short and long term finance to state farms. As a result, CBE did not have to do this and thereby escaped the almost total inability of the state farms to service their debts. They were loss-making, despite being paid higher prices for their output than other farms. Their financial problems were made worse by being set up with 100% loan capital, but even the provision of equity finance would not have been enough to make them viable.[10]

The third government-owned bank, the Housing and Savings Bank (HSB), concentrated on an area of lending to which the CBE was also not under any pressure to lend, namely the purchase and construction of buildings. Although the HSB was not profitable, its

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[10] Note that, very unusually, financial sector policy did not include any pressure on existing financial institutions for lending to small and medium scale enterprises, which might otherwise have been a source of bad debts. The government's priority was the development of public enterprises, not the private sector.

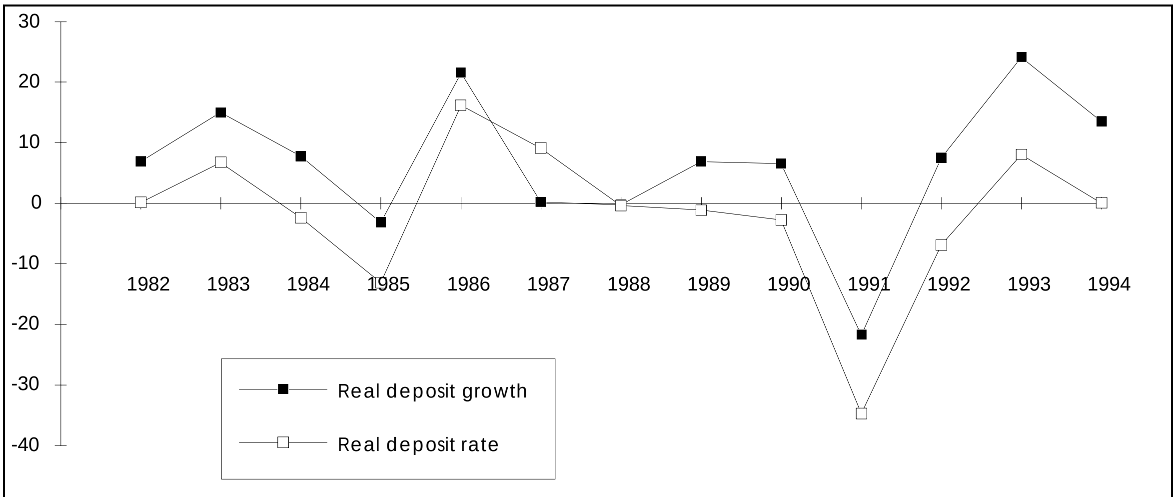
losses were modest. It is unlikely, therefore, that the CBE would have been endangered if it had been obliged to cover this area of lending.[11]

3.4 Interest rate policy and the real growth of bank deposits

During the socialist period, the government appears to have been supremely unconcerned about interest rates. The nominal deposit rate was almost unchanged from 1981 until 1989 (there are no official records of interest rates prior to 1985 other than the Treasury Bill rate, which was 2.80% in 1981 and unchanged at 3% from 1981 to 1991). Significantly, annual reports of the central bank and CBE contain a wide range of statistical tables, but there is no table of interest rates in either publication, and in year after year there is no mention of interest rates in their text.

During most of the period since 1981, therefore, the main determinant of the real deposit rate was the rate of inflation;[12] the range of real deposit rates was from -36% to +16%. The response of depositors, as measured by changes in the real value of interest-bearing deposits, followed changes in the real deposit rate quite closely, as can be seen in Figure 1.

Figure 1
Real growth in interest-bearing deposits and real interest rates
(percentages)



Source: International Financial Statistics

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[11] The Housing and Savings Bank did, however, cooperate with the Commercial Bank of Ethiopia: the latter acted as agent for the former in areas where HSB did not have branches.

[12] The real return to bank deposits should normally be adjusted downwards to allow for taxation. However, income from bank deposits was taxe exempt in Ethiopia.

Somewhat surprisingly, despite the neglect of interest rate policy causing the real interest rate to be negative more often than not, there was significant real growth in deposits. Figure 1 shows that the real value of time and savings deposits grew in most years. Real interest bearing deposits did indeed decline in value in those years when the real deposit rate was *heavily* negative, but there was positive real growth in the years when the real deposit rate was only *slightly* negative. As a result, the real value of time and savings deposits more than doubled in the thirteen years from 1981 to 1994.

Part of the explanation may be that the real deposit rate was only heavily negative in two years, and that there were also years of positive rates. This contrasts with many other African countries, where real interest rates were consistently negative, and negative by large amounts. In those countries, depositors developed expectations that real interest rates would continue to be negative, and therefore avoided holding money balances denominated in domestic currency as far as was possible. In Ethiopia, on the other hand, real interest rates were never negative for very long, with years of positive real rates interspersed. This apparently prevented inflationary expectations from becoming established.

A further explanation for the absence of inflationary expectations is that a large part of fluctuations in the rate of inflation was the result of variations in rainfall. In turn, rainfall variations caused fluctuations in food prices, which comprised 49% of the consumer price index. Increases in inflation caused by drought are in principle temporary, and are viewed as such. They may cause farmers to reduce their real money balances in order to buy food to substitute for failed crops, and non-farmers to pay higher prices for food, but they do not cause expectations of continuing inflation. In contrast, there is no similar reason to expect repeated budget deficits financed by money creation to be temporary, so that when they cause inflation year after year, inflationary expectations are created.

Table 3

Measures of money in real terms 1981-93
(B million, constant 1985 prices)

End of year	M1 (non-interest bearing)	Quasi-money (interest-bearing)	Broad money (M1 + quasi-money)
1981	2334	974	3308
1993	4488	1959	6447
Change	+92%	+101%	+95%

Source: International Financial Statistics

The fact that holdings of interest-bearing deposits in Ethiopia increased in most of the years when the real deposit rate was negative suggests that other factors influenced the longer term trend. This is supported by the behaviour of non-interest bearing forms of money holdings. As shown in Table 3, demand deposits and the public's holdings of notes and coin (M1) rose in real terms by roughly the same amount as time and savings deposits.

3.5 The real growth of deposits: other factors

There was no particular reason in Ethiopia for people to fear that government would appropriate monetary assets, as happened in Ghana and Uganda, for example, where bank deposits were confiscated and money holdings taxed respectively. It may be of to note that something outrageous did not happen, and this factor cannot explain the growth of deposits; but it at least contributes to explaining why the ratio of money to GDP did not fall. Nor can the real growth of the demand for money be explained by economic growth, which was almost negligible over the period. Real GDP grew by less than 0.5% a year, or less than 5% overall, between 1981 and 1993, compared with the doubling of real money balances.

A possible explanation of the growth in measures of money in real terms, and as a proportion of GDP, is the expansion of the branch banking network, from 83 branches in

1975, to 154 in 1994.[13] However, bank deposits grew no faster than the notes and coin in circulation, although more people were in a position to open bank accounts.

The relative unimportance of new branches is supported by the fact that many of the CBE's new branches were small and unprofitable [CBE 1991/92:27], and is further confirmed by an econometric study. This tested the significance of changes in the population per bank branch in explaining changes in domestic savings in five African countries, including Ethiopia. Population per bank branch was statistically significant in each sample country except Ethiopia, where the coefficient was of the wrong sign and statistically insignificant [Ikhide, 1995].

Overall, the doubling of bank deposits during the socialist period cannot be explained by any of the obvious candidates: real interest rates, economic growth, additional bank branches. It appears that the long term monetisation of the economy proceeded in the absence of any strongly negative factor, and perhaps also because the ownership of land (an obvious alternative savings medium) was not permitted. Alternatively, it is possible that suppressed inflation exaggerated the real growth of money balances, and that shortages of consumer goods caused people to increase their money balances because there was little on which to spend their money. It has also been argued (using evidence from several African countries including Ethiopia) that war creates profitable trading opportunities with strong incentives to save in liquid forms because other assets are too risky [Collier and Gunning, 1995].

4. Financial sector reform in the 1990s

4.1 Objectives of policy changes

Economic liberalisation began before the fall of the Mengistu government.[14] Neither then, nor in the statements of the successor government, did financial sector reform appear as a priority [Brune 1994; Transitional Government of Ethiopia, 1992; Hansson 1995]. The commitment to continued government ownership of existing financial institutions was extremely strong. The government was also very determined not to allow foreign banks into Ethiopia, not even as minority partners with Ethiopian banks.

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[13] Prior to 1975, the Commercial Bank of Ethiopia's reputation was that it was used only by urban people. Peasants borrowed from landlords, who therefore had an interest in preventing extension of banking services. After the revolution, landlords disappeared; and CBE and AIDB disbursed loans only through producer and service cooperatives. Private farmers received only 0.1 per cent of AIDB loans from 1975 to 1987 [Naude, 1994].

[14] Market-based reform began in December 1987; it was preceded by a Soviet report calling for market-oriented pricing, marketing and distribution of goods and services [Fantu Cheru, 1994].

The main institutional changes proposed were, therefore, very much less radical than elsewhere in Africa, being limited to the following:
- to allow private sector banks to operate, but only if 100% locally-owned
- to allow the two development banks, AIDB and the Housing and Savings Bank, to become commercial banks and to compete with the CBE and with each other
- to give greater autonomy in lending decisions to CBE
- but to keep the three government banks in 100% government ownership.

In addition, the government committed itself to a policy of positive real interest rates. This made little difference in practice. Although real interest rates had been negative in a majority of years, those years were interspersed with years when real interest rates were positive (see Figure 1). Financial repression was not severe, therefore. Nor was there any immediate need to attract additional deposits into financial institutions because they had excess liquidity. Meanwhile, interest rates continued to be dictated by the central bank. There was no market in either government bonds or Treasury Bills on which a market-determined interest rate might have been based. Nominal interest rates were raised in 1993 but held constant thereafter so that real interest rates fluctuated according to the rate of inflation, as they had done for many years. Figure 1 shows no noticeable difference in the behaviour of real interest rates in the most recent years, compared with earlier years.

4.1 Impact of financial liberalisation on banks: Commercial Bank of Ethiopia

The Commercial Bank of Ethiopia remained in 100% government ownership, but it was given greater autonomy in lending decisions, especially from September 1994. It also acquired its own Board of Directors. Even before these institutional changes, there was a sharp increase in loans and advances, within which there was a major shift to lending to the private sector. This sharp increase in lending came after a prolonged period of stagnation: from 1981 to 1989, the real value of CBE loans and advances remained constant in real terms, and then fell 37% in the three years to 1992 (Table 4).

Thereafter, the real value of lending to public enterprises rose 77% in two years, but lending to the private sector rose even faster, more than tripling. The share of the private sector increased, therefore, from, 31% to 46% of total lending (see Table 6 below).

Table 4

Loans and advances of Commercial Bank of Ethiopia, in real terms
(B million, 1985 prices)

Year	Public Enterprises	Cooperatives	Private and Individuals	Total
1981	849 (63%)	4 (0%)	497 (37%)	1350 (100%)
1989	884 (70%)	22 (2%)	360 (28%)	1266 (100%)
1992	535 (67%)	14 (2%)	250 (31%)	799 (100%)
1993	899 (60%)	20 (1%)	588 (39%)	1507 (100%)
1994	948 (52%)	39 (2%)	836 (46%)	1823 (100%)

Note: numbers in brackets are percentages of total lending in that year.

Source: Commercial Bank of Ethiopia, Statistical Review, June 1994

Such a rapid rate of increase in lending could have endangered the quality of the bank's loan portfolio. The capacity of any bank to control the quality of its lending could be endangered by such a large increase (more than doubling in real terms) over as short a period as two years.

In this particular case, the bank had also to cope with a major shift in the structure of its lending, and therefore with the criteria for making loans. Years of lending to public enterprises on government instructions, with an implicit government guarantee, could be expected to have reduced the bank's knowledge and experience of lending using commercial criteria. The CBE said that lending to public enterprises was no longer at government direction, but it also said that government had repaid debts of public enterprises that were closed while remaining public enterprises were profitable. There was not therefore any conflict between commercial and non-commercial criteria, and the implicit guarantee of lending to public enterprises appeared to have been maintained. However, the enormous increase in lending to the private sector was clearly a potential source of greatly increased bad debts.

Second, there was a change in the lending environment. During the socialist period, central allocation of foreign exchange acted as a substitute for assessing the viability of borrowers. Liberalisation of foreign exchange allocation made assessment of the quality of loan applications more difficult, requiring different skills.

However, the bank claimed that its lending officers were capable of handling this upsurge in private sector lending. It was argued that the socialist period lasted "only sixteen years", so that relevant experience from before the fall of the imperial government remained available in the bank. Note, though, that the managers in question missed out on most of the commercial experience which they would have accumulated during the previous sixteen years if the government had not directed the majority of the bank's lending.

Third, as noted above, the bank continued to do credit analysis of lending decisions throughout the socialist period, and to train banking staff accordingly. The bank continued with this policy even though it was unable to take collateral from public enterprises, and was not able to refuse government instructions to lend.

A fourth point is that some 60 to 65% of the recent increase in lending to the private sector has been to existing borrowers, especially to importers, exporters and domestic traders. The number of private sector borrowers has not therefore increased as fast as the total loans outstanding to the sector. It was argued that this enabled the increase in private sector lending to be handled without overstretching the bank's capacity to avoid excessive accumulation of bad and doubtful debts.

Fifth, the bank argued that it was previously operating below the capacity of its management to handle lending decisions and pursue loan recovery. The existence of spare management capacity was made more likely by the large fall in loans and advances from 1981 to 1992 (always assuming that management capacity was not also reduced).

Sixth, it is noteworthy that commercial law and its implementation were not changed during the socialist period. The law and the courts did not, therefore, require fundamental reform to service a shift to private sector activity. They were said by bankers to be adequate for providing banks with the necessary legal support, for the pursuit of loan repayment, and the realisation of collateral, in a newly commercial environment.

It is probably too soon to assess whether this confidence, concerning the CBE's ability to increase its lending using commercial criteria without suffering from excessive bad debts, is justified. The bank has continued to publish its annual provisions for bad debts; they were slightly higher than in most previous years in 1993 (at 2.5% of total loans compared with an average of 2.0% from 1981 to 1992), and sharply below average in 1994 (at 1.3%). It is not clear whether this truly represents current lending experience; any increase in inability to repay the recent rapid increase in lending may not yet have become apparent. Indeed, the apparent fall in provisions in 1994 could simply represent provisions continued at a normal level on "old" lending, which would then appear as a smaller proportion of total lending because the total increased so fast.

A worrying point is that the CBE has reduced its requirement for collateral from 200% to 100% of the loan, with the objective of encouraging lending to the private sector. While 200% was excessively cautious, the new figure appears inadequate: it allows nothing for adverse price changes in the value of collateral, nor for the expense of realising it.

As part of an internal study (organised in 1994), the CBE was considering whether it should diversify into other banking activities, such as leasing, factoring, lending to agriculture (previously the responsibility of AIDB), the management of non-government pensions (at present pension funds are invested in savings accounts only) and longer term lending. Diversification seemed premature at a time of rapid increases in lending, and rapid changes in its structure.

The internal CBE study also sought ways of improving efficiency. That seemed unlikely without genuine competition, which in turn seemed unlikely between the existing government banks. It is generally the case that public enterprises exposed to potential competition seek ways of protecting themselves, rather than responding to competition by becoming more efficient. This is even more likely if the proposed competition is within the public enterprise sector, rather than being between public and privately owned enterprises. Unfortunately, early indications in Ethiopia indicated that this non-competitive response was likely.

For example, the CBE had been acting on an agency basis for the Housing and Savings Bank in certain areas. Although this arrangement was to end, the past habit of cooperation seemed likely to continue rather than to be replaced by competition. Moreover, the CBE said that it expected to "complement" rather than compete with the AIDB when it became a commercial bank early in 1995 (see below). Some competition can be expected from the new locally-owned commercial banks, but they will be too small for many years (if they survive) to provide significant competition to the dominant government banks. The new banks will have only a small number of branches initially, their management capacity will be limited, and their small initial capital base will not enable them to lend to CBE’s large corporate customers.

Moreover, the bank was highly liquid despite the rapid increase in loans and advances in the period since 1992. In mid-1994, loans were still only 44% of total deposits (compared with 26% two years earlier). The liquidity ratio, liquid assets as a percentage of demand deposits, was 88% compared with a formal requirement of 15%. This excess liquidity gave the bank scope to continue increasing its lending, especially its lending to the private sector, very fast for several more years.[15] The bank did not therefore have to improve the quality of its services in order to attract additional deposits.

Overall, the CBE is at risk of expanding its lending to the private sector faster than its capacity to manage this lending efficiently. Risk is increased by the new economic environment, where foreign exchange allocations no longer guarantee the profitability of borrowers. Lending to public enterprises may also have become riskier, to the extent that government really intends to end the implicit guarantees of their borrowing.

On the other hand, the CBE survived the socialist period, and the subsequent changes, in apparently sound condition. It appeared deeply conservative in its lending practices. This was a facet of its being very bureaucratic, which means that its service to the public was slow and user unfriendly. These characteristics are unlikely to change quickly, if at all. Although they offer a major marketing opportunity to new banks (see below), they may also protect the CBE to some extent from the dangers of rapid expansion of its lending.

4.2 Impact of financial liberalisation on banks: Housing and Savings Bank (Construction and Business Bank)

As already mentioned above, the Housing and Savings Bank (HSB) was in the process of converting itself into a commercial bank in 1994, changing its name to the Construction and Business Bank (CBB) in October [EIU, 1995]. With typical Ethiopian caution, the transformation was to be "sequenced", a word frequently used by Ethiopian bankers to describe (and justify) the slow pace of economic reform. Initially, new activities were to provide current accounts and short term finance, together with medium term loans for capital equipment. Historically, the bank provided finance for the purchase, extension, renovation and construction of houses for individuals and cooperatives, and recently began to finance industrial construction; these were expected to continue to be its main business.

[15] In 1994, lending was constrained by confusion over the status of title to urban land. Bankers interviewed expected this problem to be quickly resolved. Other sources were less optimistic.

The bank was always profitable, except in the financial year 1993/94 when officially determined interest margins were reduced. However, in the previous year (1992/93) a "surplus" (of B2.9 million) was more than accounted for by reducing provisions for doubtful debts from B6.0 million to B2.5 million, for which no explanation was given. This provision for doubtful debts was stated by the Audit Services Corporation to be "inadequate" to the extent of about B6.5 million. The bank was seeking a government subsidy to cover this loss, again demonstrating the expectation that government would reimburse government-owned banks for losses that could be attributed to government policy.[16]

The major sources of finance were time deposits (virtually all from public enterprises) and savings deposits (only 12% from the public sector, the remainder from the general public). Recently the bank also received long term loans from the Commercial Bank of Ethiopia and the Ethiopian Insurance Corporation. As can be seen from Table 5, three quarters of the HSB/CBB's resources in 1993 derived from the public sector, both time deposits and long term loans. Some of this was redeposited with government banks, but the majority was lent to the private sector: cooperatives (the largest category), individuals and private businesses. The bank therefore acted to a considerable extent to transfer public sector money to the private sector; to a much lesser degree it collected individual deposits for on-lending within the private sector. Recently, private sector businesses have also begun to hold savings deposits.

[16] While this incident undermines the credibility of HSB/CBB accounting practices, it adds credibility to the independence of the Audit Services Corporation in monetary public enterprise accounts.

Table 5

Housing and Savings Bank (now Construction and Business Bank): Public Sector Share of Liabilities and Assets, June 1993

(B million; percentages in brackets)

	Public sector	Private sector	Total
Liabilities			
savings accounts	16 (12%)	118 (88%)	134 (100%)
time deposits	232 (99%)	2 (1%)	234 (100%)
long term loans	195 (86%)	33 (14%) (a)	228 (100%)
capital etc.	20 (100%)	-	20 (100%)
Total	463 (75%)	153 (25%)	616 (100%)
Assets			
cash (net)	204 (100%)	-	204 (100%)
lending	140 (34%)	267 (66%)	407 (100%)
fixed assets	5 (100%)	-	5 (100%)
Total	344 (57%)	267 (43%)	616 (100%)

Note: (a) Long term loans from the "private" sector consist mostly of World Bank loans to the government on-lent by the Ministry of Finance to the bank together with B5 million outstanding from the UNCDF.
Source: Housing and Savings Bank Annual Report 1992-93.

In the year prior to becoming a commercial bank, staff attended the training institute in Addis Ababa used by all banks, to develop the new skills required. Three months prior to becoming a commercial bank, HSB/CBB also hired two retired bank officials who had worked for the Commercial Bank of Ethiopia. No foreign expertise was sought. At best, therefore, it seemed that CBB would be able to imitate the procedures and services of the CBE, in the limited number of branches (eight out of eighteen) in which the new commercial banking services were to be offered. It was said that branch managers were previously underemployed, and would therefore be able to handle both the new commercial lending and their previous lending responsibilities. Even if there really was unused management capacity, this did not establish that managers would be able to manage both types of lending successfully.

CBB management expected to compete with the Commercial Bank of Ethiopia. This directly contradicted the CBE statement that the two banks would complement rather than compete with each other. In the circumstances described, it is difficult to see how the two banks would compete. They would be using the same procedures and therefore offering a very similar service; the government controlled interest rates; they planned to lend to noncompeting parts of the market; the HSB/CBB's dependence on public sector resources made the bank vulnerable to the withdrawal or non-renewal of public sector deposits; and neither bank had any previous experience of competition.

A further transitional problem was that CBB, when it was HSB, had no board of directors of its own. All government-owned banks had the same directors, who were government ministers plus the Governor of the central bank. In practice, this meant that the board seldom met and virtually all significant decisions, including lending decisions, were made by senior HSB managers. The proposed new board of directors had not been appointed at the end of 1994, and it is difficult to see how people with any significant banking experience could be appointed other than former employees of the government banks, none of whom would have much commercial experience.

4.3 Impact of financial liberalisation on banks: Agricultural and Industrial Development Bank (AIDB)

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

After the change of government in 1975, the proportion of AIDB's lending to agriculture increased from 48 to 80% by 1981, mainly for the start-up and operation of state farms. The resources for this lending came from the central bank.[17] In 1992, the bank was insolvent, with an accumulated deficit of B186 million considerably greater than capital of B100 million, even though it had not been acknowledged at that stage that lending to state farms would have to be written off. The auditors' report was heavily qualified.

There was a major capital restructuring in 1994. Loans to state farms were written off. Some medium and long term loans from the government and the central bank were converted into equity; some central bank loans were cancelled; and a smaller amount (B250 million) was partially replaced by government bonds to be made available over five years. The net result was to reduce the balance sheet from approximately B2.5

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[17] In 1992, the item "Borrowings from National Bank of Ethiopia for lending to state farms" was 58 per cent of liabilities; some 9 per cent came from the World Bank Group (on soft terms from IDA) and most of the remainder also came from the National Bank of Ethiopia.

billion to B1 billion. This was stated to be enough for the bank to meet capital adequacy ratios.

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

Initially, the plan was for AIDB/DBE to accept deposits only from borrowers. This would add only a limited amount to deposits, so that the bank would remain dependent on the public sector for most of its resources. Management used the same rather optimistic argument as the Commercial Bank of Ethiopia, that sufficient expertise remained, from before the socialist period, for the sound management of a rapid increase in lending to the private sector using commercial criteria.

Meanwhile, like the other government banks, DBE's formal board of directors remained the high level group of cabinet ministers, chaired by the central bank Governor, which meets very seldom. In practice, this meant that lending decisions were made by the management, although loans greater than B2 million had to be approved by the Governor. This arrangement seemed inappropriate for a more commercial attitude; central bankers have neither the training nor the experience for making commercial lending decisions. It had been decided that the DBE would have its own board of directors, but it had not been appointed at the time of it becoming a commercial bank, nor were plans for its establishment being actively considered by the Prime Minister's Office.

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

4.4 Impact of financial liberalisation on banks: indigenous commercial banks

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

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

It seemed likely that the new banks would find it easy to attract deposits, and this proved to be the case. The existing banks, in particular the Commercial Bank of Ethiopia as the only commercial bank in the past, were very slow, bureaucratic and user unfriendly. Given the monopoly position of the Commercial Bank of Ethiopia, this was not surprising. Moreover, individuals were not generally allowed to open current (checking) accounts. This created an opportunity for new banks to compete successfully for deposits, by offering a better service. Moreover, they did not have to use political connections to attract deposits. This reduced their need to try and use political connections to attract deposits, and therefore protected them from the subsequent withdrawal of deposits for political reasons, a factor which contributed to the downfall of some indigenous banks in Kenya and Zambia, for example.

The new indigenous banks were handicapped initially by there being no way of investing liquid assets so as to earn interest. The National Bank of Ethiopia would not pay interest on deposits, there was no market in Treasury Bills at all,[18] and the Commercial Bank of

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[18] The Commercial Bank of Ethiopia had been obliged to buy Treasury Bills in earlier years, but its holding were constant in nominal terms (B539 million) from 1988 to 1992, falling slightly (to B528 million) in 1993 and

Ethiopia refused to allow the deposit of shareholders' money in interest-bearing savings accounts. New banks were therefore unable to earn any income on the capital subscribed before they began operations. This situation forced new banks to pay all initial expenses out of capital. However, a Treasury Bill auction was initiated in January 1995, before any of the new banks began operations.

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

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

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

1994. There was no opportunity for institutions in the private sector to buy Treasury Bills when issued, nor was there a secondary market. However, it was reported that plans were in process for a Treasury Bill auction.

4.5 Banking legislation and supervision

The new banking law [Proclamation No. 84/1994] was passed in January 1994. This established the minimum capital requirement for establishing a commercial bank (B10 million, US$1.7 million at end-1994) and capital adequacy ratio (8% of risk weighted assets).[19] Any applicant complying with the proclamation's provisions may be granted a licence. The proclamation says nothing about the central bank having any right to approve of the applicant's directors and senior management, other than that their names, occupations and addresses should be supplied, and that anyone associated with a previous bank failure requires specific permission to be involved with a new bank. This seemed to reduce the central bank's discretion to prevent the establishment of banks by people with inadequate experience or with inappropriate motives.[20]

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

Second, there were no rules laid down about provision for doubtful debts other than that they should be to the satisfaction of the central bank. It would be unusual for such rules to be stated in the legislation. Nevertheless, failure to provide adequately for doubtful debts is a risk which it is particularly important to minimise in the case of new and small banks, especially where there is so little prior experience of supervising private sector banking. It would therefore have been prudent to establish the rules in legislation. Informally, the central bank required 25% of sub-standard loans to be provisioned

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[19] There was no provision in the legislation for adjusting the minimum capital for inflation, so that it was bound to decrease in real terms; the capital adequacy ratio avoids this problem so that existing banks will have to add to their capital and reserves to keep pace with inflation. Without changing the law, it will become progressively cheaper to start a new bank.

[20] It was reported, for example, that a prospective applicant for a banking licence in another African country gave as his reason for applying that the existing banks would not grant him credit. This indicated clearly his intention of using his bank to extract deposits from the public for his own use. He was refused a licence. It is rare for applicants to reveal their intentions so obviously, but legislation should give the licencing agency sufficient authority to be active in investigating the suitability of applicants.

against, with quite cautious definitions of sub-standard, but regulations had still not been agreed formally and published.

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

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

5. Conclusions

Financial sector reform was a relatively minor part of the economic reforms undertaken before and after the fall of the previous government. Yet the banking sector was expected to support a major shift in the economy to private sector activity while undergoing considerable change. The two government development banks were transforming themselves into commercial banks, and for the first time since before 1975 private sector commercial banks were allowed to operate. There was, however, no intention of privatising the government banks, or of allowing any participation by foreign banks. The new private sector banks were obliged to be 100% Ethiopian-owned, even though at least one of them would have liked a foreign partner. This determination to develop the banking sector without foreign participation went further than the question of ownership. Transformation of the government banks, including the internal review of the Commercial Bank of Ethiopia, was being undertaken without foreign technical assistance; the new private sector banks were using virtually no foreign expertise; and the new banking legislation showed few signs of external influence.[21] There was some willingness to try to employ the skills of Ethiopians working abroad, but the salaries available locally were generally not high enough to attract exiles with appropriate professional skills and experience.

There is a general preference in Ethiopia for developing new policy using indigenous resources only, believing that long term development is enhanced by people learning from their own mistakes. In most aspects of development, this approach is clearly better than using foreign ideas and technology which is not based on an understanding of local conditions, and has not involved locals in its preparation and implemented. The failure of foreign investors, and of expatriates working in technical assistance programmes, to transfer their knowledge and experience has been powerfully criticised [Berg 1993; Kanbur 1995].

In banking, however, the cost of mistakes in the form of bank failures can be very high, arguably higher than the benefits of learning by trial and error. The direct costs include the burden on the government budget of writing off bad debts and recapitalising government banks.[22] In addition, there is no guarantee that rehabilitated banks will remain solvent, so that both types of cost may recur at some later period.

The indirect costs include slower development of the financial sector, and therefore reduced availability of credit, higher costs, and slower development of new services. It becomes more difficult to enforce loan repayment when non-repayment has been permitted in the past, and it becomes even more difficult if governments finance the writing off of bad debts. Sound indigenous banks lose deposits when unsound ones fail, and have to pay higher rates of interest in order to retain some deposits. These factors reduce the quantity and increase the cost of resources available for lending, especially to small and and medium scale businesses.

The history of banking in Ethiopia gives some support for arguing that these problems may

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[21] The IMF was consulted at an early stage of drafting the new banking Proclamation, but not subsequently.

[22] Bad debts in some government-owned commercial banks, expressed as a proportion of government spending in 1992, ranged from 9 per cent in Uganda to 55 per cent in Tanzania, with intermediate figures of 18 per cent in Ghana and 35 per cent in Mozambique. Calculations based on known shares of government commercial banks in the commercial bank market and estimates of their ratios of bad debts [International Financial Statistics; Harvey 1995:145; interviews 1995].

be avoided. The government-owned banking sector was in a relatively sound financial condition during the early period of financial sector reform. There was nevertheless some risk that the shift to lending to the private sector, in an unfamiliar economic environment, while the two government development banks were also transforming themselves into commercial banks, would overstretch management capacity. The risks involved in too rapid a rate of change were increased because the new banking legislation was inadequate on some important prudential issues, and because of the unprepared state of banking supervision. The latter was particularly worrying because new small indigenous banks were starting operations. The risk was increased in Ethiopia by exceptional pressure on the indigenous banks to increase their lending rapidly, because the rate of return on bank lending was so much higher than on the only available liquid assets, Treasury Bills.[23] It would be very damaging if one or more of the indigenous banks were to fail. This would make success more difficult for survivors, and for new banks trying to become established in the future, and would reduce competition.

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

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[23] The first new bank to complete a year's operations reported that it made a first year profit. That is extremely promising, although it was almost certainly too soon for evidence of problem lending to emerge.

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This paper draws on interviews with bankers, government officials and others in Addis Ababa in late 1994 and early 1996, to whom grateful thanks are due.

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