THE STRUCTURE OF FINANCIAL SYSTEM IN ETHIOPIA

[1]Habtamu Gemeda Wagno, [2]Navkiranjit Kaur Dhaliwal, [3]Rajeev Kansal
[1]Department of Commerce, Punjabi University, Patiala, India
[2, 3]Professor, Department of Commerce, Punjabi University, Patiala, India

Abstract: The objective of this study is to examine the structure of the financial system in Ethiopia by reviewing the institutional framework related to the financial affairs of the country. The findings of the study indicate that the design of the financial system of Ethiopia is bank based, comprises a set of formal, semi-formal and informal institutions and markets and dominated by state ownership. Besides to this, the structure of the financial system of Ethiopia lacks the key features of modern financial systems such as an organized securities exchange market and the participation of foreign investors in the financial sector of the country. Moreover, capital and derivative markets and pension fund institutions are at low-level development and not properly integrated into the financial system of the country. To this end, authorities have to work on strategies for institutional integration of market players, introduce organized exchange market for primary and secondary securities, and strengthen the regulatory and supervisory capacities to ensure the development of a sound financial system in the country.

Keywords: *Ethiopia, Financial System, Financial Markets, Structure, Exchange Market, Formal Financial System*

1. Introduction

Over the last two decades, though the Ethiopian economy is among the fastest growing economies in the world and the financial system has gone through different stages of development, it is still underdeveloped. Recent studies imply that the Ethiopian financial system is small and people access to […] (finance) is the lowest even by the Sub-Saharan Africa (SSA) standard (Ashenafi and Daniel, 2016 and Tefera, 2016), not yet registered level of development to support long-run economic growth (Dejene, 2016 and Abebaw, 2014) and closed to foreign entry (Mekonnen, 2017). It is characterized by underdeveloped regulatory framework (Alemayehu et al., 2017), weak regulatory and supervisory capacity (Alemayehu, 2006), dominated by state-owned banks (Kiyota et al., 2007) and lack of organized security exchange market (Abay, 2011 and Kapur and Abebaw, 2012). Furthermore, equity and bond markets, pension fund institutions and the derivative markets are not integrated into the formal financial system. On top of all, there are no institutional and legal frameworks that regulate the market for stock exchange (Jetu, 2014) and structural framework that shows its institutional integration, regulatory and supervisory hierarchies.

Notwithstanding, the debate on the further liberalization of the financial system in Ethiopia is central and hot in development and legal literature. At the center of the argument as Levine (2005) explains is countries with better functioning banks and markets grow faster […] and better functioning financial systems ease the external financing constraints that impede firm and industrial expansion. Furthermore, financial services provide economic opportunities for the poor people allowing them to create assets and income. Hence, this study, argues that in addition to the mounting evidence outlined above, the lack of a structural framework is among the principal causes to the low level of financial development of the country. This study, therefore, examines the current structure of the financial system in Ethiopia and construct a structural framework to further show the structural gaps in the financial system of the county.

2. Literature Review

Theoretical and empirical literature describe the financial system as a set of interlinked entities working in harmony to facilitate the mobilization and transfer of resources from one unit to another in the whole economic system of a county. According to Hawkins (2006), the financial system comprises a number of interrelated components infrastructure (including legal, payment, settlement and accountancy systems), markets (stock, bond, money, and derivatives) and institutions (banks, securities firms, and institutional investors). Likewise, Ang (2008) explains that financial system is a sector in the economy that utilizes productive resources to facilitate capital formation through the provision of a wide range of financial services to meet the different requirements of borrowers and lenders. Furthermore, Levine (1997) indicates that the financial system facilitates investment through capital formation and technological innovation which result in economic growth. In the words of Merton (1990), the financial system includes the basic payment system through which virtually all transactions clear and the capital markets which include the money, fixed-income, equity, futures, and options markets and financial intermediaries. Generally, the financial (system) sector contains a number of separate, though interdependent, components such the set of intermediaries, markets in which claims are exchanged and the infrastructure that includes securities exchanges and payment and settlement systems […] necessary for the effective interaction of intermediaries and markets (Crockett, 2011). The notion of explanations given implies the structure of the financial system, which deals with which kind of financial institutions and market structures serve best in mobilization and utilization of resources. The financial structure is defined in terms of the aggregate size of the financial sector, its sectoral composition, and a range of attributes of individual sectors that determine their effectiveness in meeting users' requirements (The World Bank (WB) and International Monetary Fund (IMF), 2005).

In literature, there are solid shreds of evidence that developed, the efficient and stable financial system is the key to support sustainable economic growth. Before a century ago, it is theoretically argued in Bagehot (1873) and Schumpeter (1912) as in King and Levine (1993) that finance plays a key role in promoting economic growth. Empirically, studies by King and Levine (1993), Rajan and Zingales (1998), Beck and Levine (2004), Levine (2005), Bittencourt (2012) and Beck et al. (2013) ascertain financial development promotes long-run economic growth. Most recently, burgeoning works of literature establish that the financial system is an indispensable ingredient of economic growth and address the channel through which financial system affects economic growth.

There are different channels through which the financial system plays a crucial role in economic growth. Beck et al. (2010) indicate financial system by effectively mobilizing savings, channelizing funds to efficient investments and monitoring of users of these funds, thereby affects long-run economic growth. Moreover, Blackburn et al. (2005) and Demirguc-Kunt and Levine (2008) stipulate that financial system by eliminating information asymmetry and reducing moral hazard problems, facilitate saving and resource mobilization hence promote investment. Furthermore, the financial system increases the efficiency of investment (Greenwood and Jovanovic, 1990 and Levine, 1997) and ease the trading, hedging, and pooling of risk with implications for resource allocation and growth (Levine, 2005) by decreasing transaction and information processing costs. Nonetheless, when the financial system performs these functions poorly, as clearly witnessed in the episodes of the recent global financial crisis, it tends to hinder economic growth by reducing rate of innovation, restrain economic opportunities, and disrupt economic stability (King and Levine, 1993; Čihák et al., 2013 and Barth et al., 2013).

In Ethiopia, while empirical studies on the structure of the financial system are scant, there are studies that have been emphasizing on specific aspects of the system. For instance, the seminal work of Alemayehu et al. (2017) argues that gradualism financial liberalization strategy while simultaneously investing in regulatory capacity is the appropriate strategy for maintaining macro-economic stability and growth in Ethiopia. Moreover, Alemayehu (2006) and Addison and Alemayehu (2001) also argue that the gradualism financial reform while investing in regulatory capacity is the appropriate strategy for maintaining macro-economic stability and growth in Ethiopia. In addition to this, Kiyota et al. (2007) identify two factors that may constrain Ethiopia's financial development; the closed nature of the sector in which there are no foreign banks, a non-competitive market structure, and strong capital controls in place and the dominant role of state-owned banks and argue that the Ethiopian economy would benefit from financial sector liberalization, especially from the entry of foreign banks and the associated privatization of state-owned banks. The study by Tefera (2016) entitled financial sector liberalization in Ethiopia: resistance, justification and its credibility show majority of populations are out of reach of financial service in the country and argue that the justification for not to liberalize the financial sector is not sound and credible.

Besides the above studies, there is also some literature on the finance and growth nexus in Ethiopia. For instance, Tekilu et al. (2018) examined the link between financial development and sectoral output growth in Ethiopia. The study indicates that in the long run financial development had a less significant positive impact on agricultural and service sector output growth. But, financial development has a positive and significant impact both in the short run and long run on industrial and aggregate output growth in Ethiopia. Nyasha et al. (2017) also investigate the dynamic causal linkage between bank-based financial development and economic growth in Ethiopia. The study found that in the short run, both financial development and economic growth Granger-cause each other while in the long run, there is unidirectional Granger-causality from bank-based financial development to economic growth. Moreover, the study by Sime (2016) establishes the existence of a bidirectional relationship between financial development and economic growth in Ethiopia and suggests the government to create a conducive condition for the development of finance to sustain its contribution for economic growth. Contrary to the above studies, Dejene (2016) establishes financial development indicators are with a negative coefficient and insignificant in the long run while in the short run it has a growth stimulating effect in Ethiopia.

In addition to these, there is some empirical analysis on the development of the financial system over a given time period in Ethiopia confirming the low level of financial development in the country. A literature review by Aderaw and Manjit (2016) indicate financial development in Ethiopia is at a low level and Abebaw (2014) remarks the financial sector is not that much developed in Ethiopia. All the above studies address that the financial system in Ethiopia is underdeveloped, closed to foreign entry, dominated by state ownership and people has low access to financial services and none tried to posit what might cause its low level of development and indicate the lack of structural framework. Therefore, this study postulates the low level of financial development is due to a lack of institutional structure and framework of the financial system in the country.

3. Data and Methods

This study entirely depends on secondary data collected from the annual report of National Bank of Ethiopia (NBE), financial, regulations, proclamations and directives, WB country update, IMF Article IV consultation and prior research work through document review. Content and framework data analysis methods have been used to analyze qualitative data while descriptive analysis was used for quantitative data. The financial structure of the country is decomposed into subsystems through examining the regulatory bodies, capital structures as well as resource mobilization practices of each entity in the economy. From this analysis, we construct the overall current financial system structure by classifying the different groups in the financial system based on the financial services they provide (by a form of organization), ownership structure (share of capital), deposit mobilization, advances and loans provisions.

4. Results

In the following three separate sections, first, the current structure of the financial system is depicted as indicated in Figure 1 below by form of organizations, second, the ownership structure of financial system in the country analyzed using capital share as shown in Figure 2 and lastly, structure of banking industry is presented to throw a light on its dominance in the structure of financial system in Ethiopia.

4.1. Structure of Financial System of Ethiopia-By Form of Organization

The analysis of existing literature indicates that by a form of organization, the financial system in Ethiopia consists of regulatory bodies, formal, semi-formal and informal systems with exhibiting features of developing countries in the world. The formal financial system comprises financial institutions and markets that are legally set up and engaged in the provision of financial services, mobilization of savings and advances and loans to anyone based on identified criteria. Figure 1 below shows the current structure of the financial system by type of organization developed by reviewing existing regulatory and supervisory legislations of governing authorities, reports of different entities and consulting prior research works.

As indicated in Figure 1 below, the financial system in Ethiopia consists regulatory bodies of the financial system such as NBE, Ministry of Trade-Ethiopia (MoT), Public Financial Enterprise Agency (PFEA), Ethiopian Commodity Exchange Authority (ECEA), and Federal Cooperative Agency-Ethiopia (FCA). In addition, the financial system includes the formal financial system which comprises banks (development bank and Commercial banks), insurance companies, microfinance institutions (MFIs), bond markets, Treasury bill markets, derivative market and the Capital Goods Financing Companies (CGFC) which are under the direct regulatory oversight of NBE, MoT, PFEA, and ECEA.

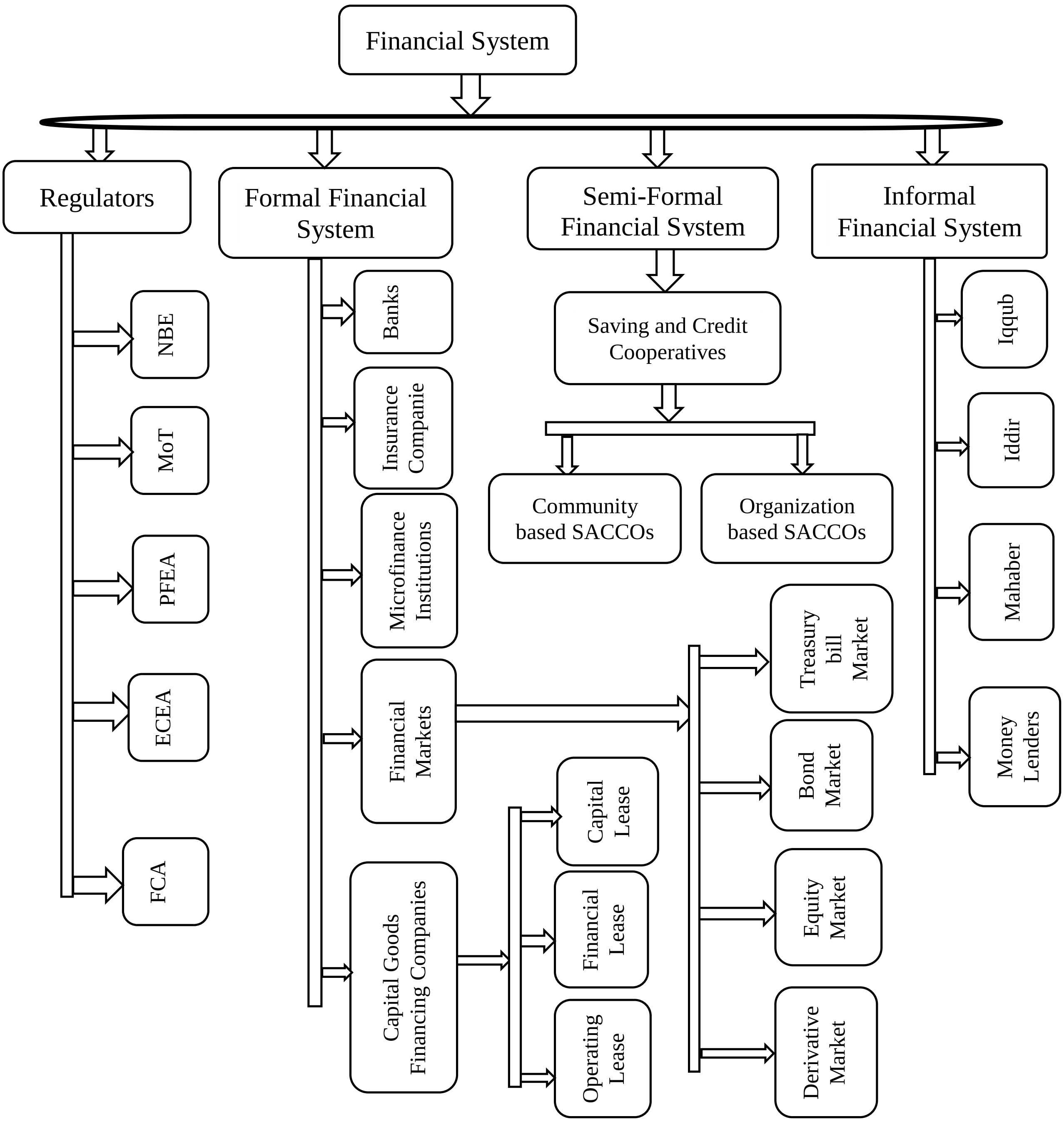
Recently, under the formal financial system, there are 18 banks, of which one is public development bank(Development Bank of Ethiopia which is non-deposit taking institution),one state-owned commercial bank(Commercial Bank of Ethiopia) and 16 privately owned commercial banks, 17 insurance companies of one state-owned and 16 are private, 35 microfinance institutions, treasury bill markets(28days, 91days, 182days and 364 days), government and public companies bond market, primary equity market for shares, derivative market for coffee and main grain types of Ethiopian Commodity Exchange(ECX) and five CGFC (NBE, 2017/18). The CGFCs are intend to provide the three types of leases such as an operating lease, financial lease and capital lease (Hire purchase).

The semi-formal financial system consists of the saving and credit cooperative organizations (SACCOs) which are regulated and supervised by respective regional cooperative agencies under the umbrella of the Federal Cooperative Agency (FCA) of Ethiopia. In Ethiopia, SACCOs are owned, governed and managed by its members who have the same common bond such as working for the same employer, belonging to the same community. SACCOs in Ethiopia are not permitted to take deposits from nonmembers. In Ethiopia, structurally, SACCOs are classified as community-based and organization based SACCOs.

The informal financial system in Ethiopia consists of unregistered traditional institutions such as *Iqqub* (Rotating Savings and Credit Associations), *Iddir* (Death Benefit Association), *Mahaber* (Religious Members gathering) and Moneylenders (*Arata Abedari*-usury as in case of most of developing countries) (see Aderaw and Manjit, 2010 and Dejene, 1993 for details on the semi-formal and informal financial system in Ethiopia).

In addition to the form of organization, Figure 1 below clearly shows the type of services provided by each sub-system in the financial system of the country. Banks, MFIs and SACCOs are depository institutions (accepting deposits and provide advances and loans) while the insurance companies are the non-depository financial institutions. Moreover, the financial markets are also can be classified as capital markets (Bond and Equity markets) and the money market (Treasury bill market) in Ethiopia.

Figure 1: Structure of Financial System in Ethiopia



Source: Developed by authors from Literature

Notes:

NBE=National Bank of Ethiopia

MoT=Ministry of Trade-Ethiopia

PFEA=Public Financial Enterprise Agency

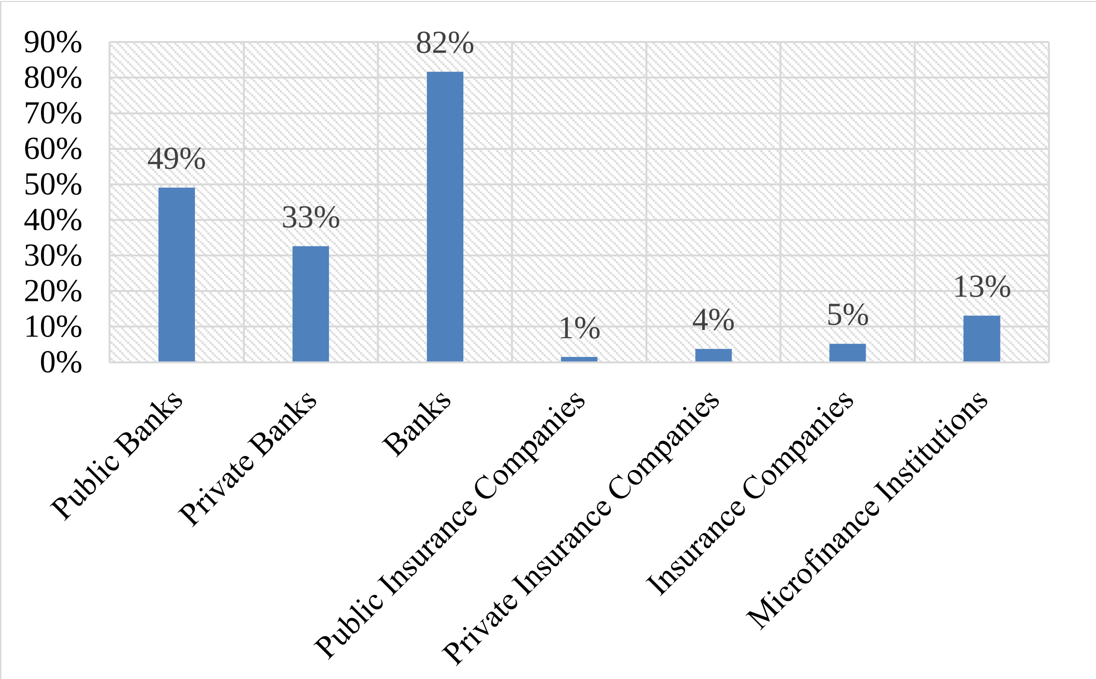
ECEA=Ethiopian Commodity Exchange Authority

FCA=Federal Cooperative Agency-Ethiopia

4.2.Structure of Financial System in Ethiopia-By Capital Share

As indicated in Figure 2 below, in the year 2017/2018, banking industry capital was 82 percent of the total capital of formal financial system followed by the microfinance institutions, about 13 percent and insurance companies own only 5 percent of the total capital of the system. This shows that the financial system in Ethiopia is bank dominated and the other sub-sectors are less capitalized as compared to the banking industry particularly the insurance industry is undercapitalized. Moreover, the financial system of a country is dominated by the state ownership (49 percent in the banking industry and 1 percent in the insurance sector). In recent years, the share of private banks, insurance companies, and MFIs continue to increase, though the journey is tough unless the state dilutes its share in the financial sector. In addition to this, sub-structural decomposition of the financial system indicates that public banks own 49 percent of the total capital structure while the private banks own 33 percent.

Figure 2: Structure of financial system in Ethiopia-By Share of Capital

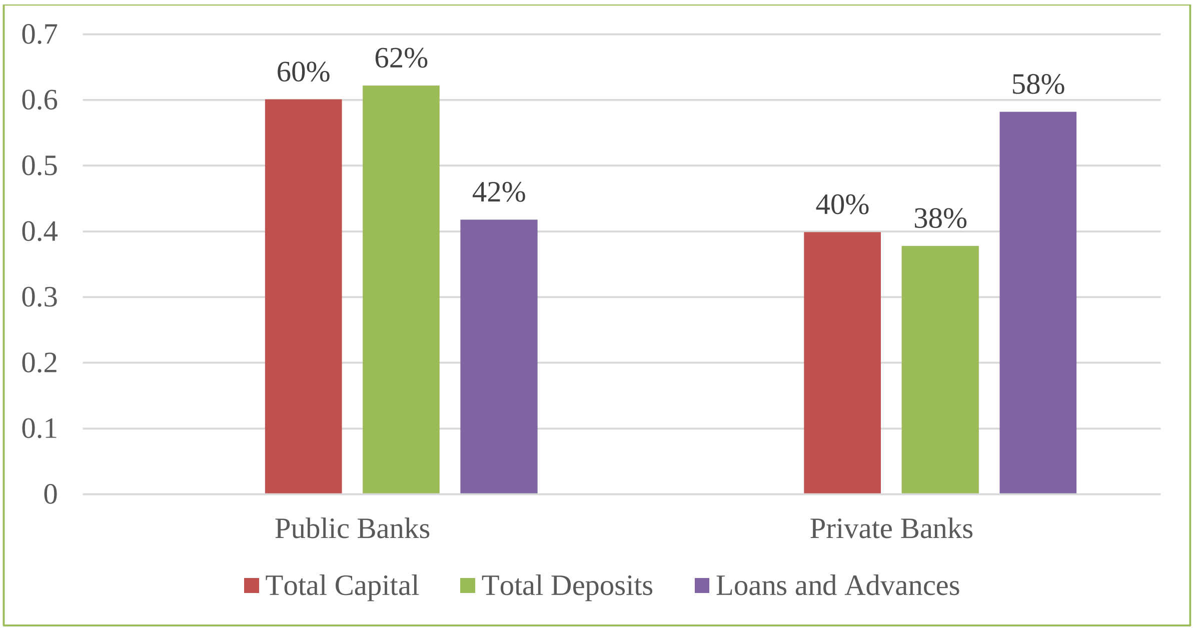


Source: NBE Annual Report, 2017/18

4.3. Structure of Banking Industry in Ethiopia

Banks plays important role in the Ethiopian financial system by mobilizing deposits and providing advances and loans. The structure of the banking industry as depicted in Figure 3 below shows that the public banks dominate the market in terms of total capital (60 percent) of total capital of banking industry and deposit mobilization (62 percent) of deposits mobilized by banks while the private sector banks lead in advances and loans (58 percent) of total loans and advances. The share of private banks in total capital is 40 percent and in deposit, mobilization is 38 percent which implies that though the private banks are recent phenomena in Ethiopia (after the 1994 financial reform) as compared to the public banks, their progressive performance is promising.

Figure 3: Structure of Banking Industry in Ethiopia



Source: NBE Annual Report, 2017/18

5. Discussion

Unequivocally, well-developed and established financial system is a sine qua non for economic growth. It enhances resource mobilization and allocation, encourages technological innovation, facilitates trade and exchange of goods and services, and affects the quality of life of people. From this point of measurement and global dimension, though the Ethiopia financial system exhibits basic features of the modern financial system and contributed to the resource mobilization and allocation of the country, it is still small and less diversified. Form the analysis, it is indicated that the financial system in Ethiopia comprises depository institutions such as banks, microfinance institutions (MFIs), saving and credit cooperative (SACCO) and non-depository institutions such as insurance companies, capital goods financing companies, and financial markets through which financial services are transacted. The design of the structure of financial system in Ethiopia is bank based as in the case of SSA countries (Ibrahim and Sare, 2018) and also exhibits the traditional financial practices of the society albeit gauge of their contribution and intrinsic characteristic needs further investigation. The structure in its intrinsic features reflects the financial system in most developing countries. For instance, informal financial system as in the case of India and Kenya, lack of exchange market, low level of equity and bond markets and pension fund development, closed to foreign investors, and absence of investment and rural finance banks as in the case some of SSA countries. In addition, the informal financial practices are not integrated with the formal and the semi-formal institutions as in the case of most African countries.

From the ownership structure aspect, the state owns more than 50 percent of the formal financial system and also has a substantial share in MFIs (regional national states have more 50 of the five big MFIs in the country).

Moreover, in the banking industry as shown in Figure 3 above, state-owned banks dominate in capital share and deposit mobilization while private banks leading in providing loans and advances.

The other potent finding of this study is the regulatory framework of the financial system of Ethiopia follows traditional approach evidence by overlapping of responsibilities of regulators (NBE and PFEA) and is not institutionally integrated(the market for equities). NBE is responsible for the oversight of some of the formal financial sector (Banks, Insurance, MFIs, lease financing companies, Treasury bill market, and bond market) while the equity market is under the Ministry of Trade (MoT) of Ethiopia. In addition to NBE and MoT, the PFEA is also responsible for the regulation of financial enterprises under the ownership of the state. The derivative market is under the regulation of the Ethiopian Commodity Exchange Authority (ECEA) through the Ethiopia Commodity Exchange (ECX), the first organized commodity exchange market in Africa.

The semi-formal financial institutions (SACCOs) are regulated by the Federal Cooperative Agency (FCA) of Ethiopia through the respective cooperative society's bureau of regional governments. The saving and credit associations are theoretically similar to the saving and loan association in the advanced economies' financial system, concerned with mobilizing savings and provide loan service at an affordable interest rate based on the amount of saving of member in the association. Despite to this, there is no formal written regulatory framework for informal financial institutions in Ethiopia, however, they have their own organizations under the local norms and traditions of the society that serves as a governing rule of their practices.

6. Implications

This study posits that lack of structural framework summed-up with weak regulatory and supervisory capacity, state dominance and absence of organized exchange market dictate the underdevelopment of the financial system in Ethiopia. To this end, authorities have to work on strategies for institutional integration of market players, introduce organized exchange market for primary and secondary securities, and strengthen the regulatory and supervisory capacities to ensure the development of a sound financial system in the country. Furthermore, the study remarks the need for preparation of master plan and clearly chalk-out the time framework for further reform the financial system of the country. The country's gradualism strategy to open the sector to foreign investors and allow entry of foreign financial institutions should be priority agenda and we recognize authority's initiative started as part of the current reform in the country to open the financial system to foreign entry. In addition to this, further empirical investigation has to be undertaken for the preparation of a comprehensive structural framework and master plan for institutional integration of the financial system in Ethiopia.

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