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POLICY BRIEF

September 2014

The Role of Public and Private Sector Banking in Ethiopia's Future Economic Growth

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Over the past decade, Ethiopia has achieved impressive economic growth averaging close to 11 percent annually.[1] The development of a vibrant and active private banking system that complements existing public sector work is considered important to Ethiopia's economic progress by a range of experts, including the World Bank, the African Development Bank (AfDB), and the International Monetary Fund (IMF). These bodies view the expansion of the private banking system in a prudent and controlled manner as key to the success of Ethiopia's "Growth and Transformation Plan (GTP)," an ambitious five-year development plan launched in 2010 to assist the country in reaching "middle income" status.

This brief considers the manner in which Ethiopia's public and private banking systems affect the development of the national economy, with particular reference to anti–money laundering and countering the financing of terrorism (AML/CFT) vulnerabilities. Although this brief will review the role these interdependent systems can play in Ethiopia's economic development in the coming years, Ethiopia is not alone in facing this challenge. Banking industry liberalization is a key consideration in a range of countries, from large economies such as India to regional neighbors such as Uganda. Furthermore, the 2008 global financial crisis has raised some important questions about the merits of uncontrolled banking industry development.

The Current Situation in Ethiopia

Compared to most countries, Ethiopia has taken a cautious approach toward the liberalization of its banking industry. For all intents and purposes, its industry is closed and generally less developed than its regional peers. The industry comprises one state-owned development bank and 18 commercial banks, two of which are state-owned, including the dominant Commercial Bank of Ethiopia (CBE), with assets accounting for approximately 70 percent of the industry's total holdings.[2] The banking industry's nonperforming loan ratio is commendably low, and profitability is good, but the dominance of public sector banking certainly restricts financial intermediation and economic growth. It contrasts with regional and international peer countries where banking industries have a much higher share of private sector and foreign participation.[3]

Microfinance plays an important role in Ethiopia,[4] and the National Bank of Ethiopia (NBE) has sought to encourage this segment via the issuance of Micro-Financing Business Proclamation No. 626/2009,[5] which provides guidance on the licensing and supervision of microfinance institutions. Despite these efforts, development of this segment has been slow because provision by microfinance institutions of the type of financial services that can be delivered by a full-fledged bank remains restricted by capacity and penetration. As of June 2012, 31 microfinance institutions were providing services to 2.9 million Ethiopians, representing just 3.6 percent of the country's estimated 80 million unbanked.[6]

The underdevelopment of the banking industry can be seen in the small proportion of the population that has a deposit account, less than 8 percent.[7] This underdevelopment restricts economic growth because it dramatically reduces the ability of the banking industry to offer savings products, which in turn hinders greater bank lending to business and entrepreneurial developments.

By comparing the level of access to financial services in a neighboring country such as Kenya, it can be deduced that there is considerable room for expansion of these services in Ethiopia. Kenya has 5.2 commercial bank branches and 9.5 ATMs per 100,000 adults, in contrast with Ethiopia's 2.0 and 0.3, respectively.[8] This lack of financial access extends to Ethiopian businesses. The 2012 Ethiopia Enterprise Survey highlights access to finance as the major developmental constraint for small (38 percent of those surveyed) and medium-sized (30 percent) businesses. This compares to a sub-Saharan African average of 21 percent and 15 percent, respectively.[9]

This situation is compounded by the government's direction, via the CBE, to focus lending and investment to public enterprises generally[10] and the regulatory requirement that a substantial portion of private sector banking's already limited lending capacity be used to purchase NBE bills equivalent to 27 percent of any new loan disbursements,[11] thus removing the possibility of investing or lending these funds.

The Arguments for and Against Private Sector Banking Development

Legitimate concerns have been expressed about allowing domestic banking expansion and the increased entry of foreign capital into Ethiopia. Such measures could result in destabilizing disruption caused by "hot money" flows and skewed allocation of credit toward more-attractive borrowers, such as larger industrial companies that already have access to bank lending, rather than smaller-scale enterprises (so-called cherry picking).[12] As demonstrated by the 2008 global financial crisis, uncontrolled banking expansion can be highly damaging for economies, particularly within the current globalized financial system.

Yet, controlled development and expansion of private sector banking, including the admission of foreign capital and operators, can deliver meaningful benefits to a country such as Ethiopia. These benefits may include improvements in the overall efficiency of the sector, the transfer of skills for employers and regulators, and greater financial stability by reducing the need for cross-border flows.[13] Thus, although mismanaged financial development can lead to financial crises, forming policies that promote successful financial development can greatly improve the environment for economic growth.[14]

The lack of domestic savings opportunities provided by private banks and the limited available access to bank credit for small businesses dramatically restrict economic growth potential. Public sector banks will inevitably lead investment in key developmental projects such as those involving infrastructure, but broad-based development is required in order to create sustainable economic growth, and this investment typically comes from private sector banks as their deposit base grows.

Expanding the banking system will create greater savings opportunities that will in turn boost funding via savings. The alternative is a country's heavy reliance on external sources, private or official value transfers such as remittances, and external borrowing. None of these approaches is within a nation's control, and thus all are unreliable. In contrast, a developed domestic savings market can be controlled and managed within a country and create a much more stable base from which investment can be made. Thus far, as the recipient of significant private and official value transfers, Ethiopia has relied less than many of its peers on external borrowing. This is a strength for the country that should be preserved if at all possible, and development of a private sector banking–led savings market will be key to maintaining this national advantage.

The Benefits for Ethiopia

The IMF notes that progress has been slow on Ethiopian reforms related to improving the domestic business climate, including liberalization of the foreign exchange regime and creation of functioning financial markets.[15] Expanding private sector banking and increasing financial intermediation are key elements of this much-needed reform that will underpin economic growth. The most recent available data indicate that Ethiopia is falling behind its sub-Saharan African peers, with credit to the private sector equal to only 14 percent of gross domestic product (GDP), a reduction of 5 percentage points since 2004, compared with the rising-peer average of 23 percent.[16]

The IMF believes that, in seeking to attain the goals set by the GTP, state-owned banks such as the CBE will come under increased strain. With the CBE representing 70 percent of total banking assets, the health of the Ethiopian economy is closely correlated with the performance of this bank. It would serve Ethiopia well to diversify the strain placed on the CBE by creating a greater role for private banks, including potentially opening access for foreign banks and offshore investors.

Ethiopia would gain security benefits in addition to economic benefits from the development of private sector banking. The current foreign exchange control regime means that illicit finance, such as the proceeds of smuggling or currency brought into the country by immigrant workers, most likely uses transference channels that are outside the regulated banking system. With these money flows occurring outside the narrow banking system, it is more difficult for Ethiopian authorities to regulate and disrupt these flows because the criminals are using methods that are inevitably more opaque than those that are closely and transparently regulated in the formal banking industry. Although the Ethiopian government is believed to have shut down some networks that were operating illegally, monitoring their usage would be challenging for any government.[17]

By allowing private sector banking to expand in conjunction with the relaxation of the current foreign exchange control regime and the continued rise of AML/CFT compliance standards driven by the Financial Intelligence Centre (FIC), the government would likely improve the extent to which the financial system can be used to combat money laundering, terrorism financing, and other forms of illicit finance.

AML/CFT Considerations

To ensure that private sector banking growth does not expose AML/CFT efforts to greater vulnerability, the FIC will need to maintain the improved standards of training and reporting that it is instilling in banks and their employees. In addition, the FIC must increase its capacity to deal with the inevitable increase in cash transaction and suspicious transaction reports.

The expansion of the Ethiopian banking sector in support of economic development will inevitably involve greater international connections, bringing with them new and expanded correspondent banking relationships. These correspondent relationships are valuable for supporting international trade but are generally recognized as a weak link in the international financial transmission system and will present potential AML/CFT vulnerabilities for Ethiopia. The AML/CFT proclamation 780/2013[18] highlights the importance of maintaining tight control over and knowledge of correspondent banking relationships, and a close focus on this area of development will be an important task for the FIC and other Ethiopian authorities.

Summary, Conclusions, and Recommendations

The AfDB notes that the Ethiopian financial sector "is not able to offer adequate and competitive services on the scale required. This is a major impediment to the expansion of productive activities.… [Furthermore,] the private sector considers inadequate access to risk capital and credit as a major impediment to doing business.”[19] The controlled development of private sector banking will significantly address these concerns, supporting the GTP and maintaining Ethiopia’s recent impressive economic growth.

Ethiopia intentionally has used tools such as low interest rates, currency appreciation, and targeted usage of credit and foreign exchange to support public enterprises and drive economic growth. This strategy has succeeded but led to the neglect of private sector development, a low national savings rate, a loss of international competitiveness, and an increase in the trade deficit. The expansion of private sector banking, as well as a more realistic foreign exchange control regime, will be key to addressing these issues and to maintaining growth in economic development.

Although not the only factors to consider, failure to liberalize the domestic banking industry, attract foreign capital, and provide greater opportunity for private sector banking investment likely will inhibit the economic growth that the Ethiopian government seeks. Furthermore, the dominant position of public sector investment is a hindrance. Ethiopia has the third-highest public investment to GDP ratio in the world and the sixth-lowest private investment to GDP ratio.[20] The IMF believes that failing to address this dominance will “undermine the [government’s] growth objectives and have contributed to the recent foreign exchange shortages” that are exacerbated by the failure to develop the private sector that would boost exports and attract foreign currency. Furthermore, the lack of private sector banking restricts the development of a savings market, a key component for allowing banks to sustain the high levels of financing needed to support the country’s investment program.[21]

Four recommendations are offered. First, because an expansion of private sector banking can undoubtedly bring significant developmental, economic, and AML/CFT benefits to Ethiopia, such expansion should be prioritized and encouraged in a controlled manner, including consideration of attracting foreign banks and capital to the country.

Second, expanding private sector banking should be encouraged so that the national savings rate increases dramatically. As a result, investment in businesses and the broader economy can be undertaken from this base of funding stability rather than through the release of foreign exchange reserves or the use of international borrowing.

Third, considering that branch networks are heavily concentrated in urban areas, primarily Addis Ababa, which accounts for nearly 40 percent of the total branch network,[22] existing Ethiopian banks should expand their networks and other forms of financial inclusion, such as mobile banking. This expansion will give the authorities greater oversight of the financial flows within the country and improve AML/CFT security.

Fourth, existing lending should be more equitably distributed between the public and private sectors. Ethiopia's total investment rate is comparatively high but is skewed toward the public sector, which has led to a restriction in private sector investment participation and growth.[23]

The controlled unleashing of private sector banking should bring significant benefits: greater savings, increased supply of credit to businesses, and support for start-up activity. It will also bring secondary benefits, such as greater exports and an increased tax base, which will create a virtuous cycle of economic growth and employment.

Furthermore, the development of private sector banking will bring security benefits as a greater proportion of the country's financial flows are brought into the regulated system, enhancing the authorities' ability to manage and oversee financial flows consistent with the Financial Action Task Force requirement for countries to maintain firm control of informal value transfer systems. Yet, this expansion needs to be carefully administered to ensure that the country's illicit finance vulnerabilities are not exacerbated, undoing the good work that has been achieved in recent years.

In considering the public and private sector banking segments, the way in which they interact domestically, and the value of liberalization and expansion, the issue is not whether such developments are good but whether these developments can be advanced in the correct way. Done improperly, they may undermine the AML/CFT security of Ethiopia and will adversely affect the development of the national economy and the growth and transformation to which the government aspires.

Endnotes

[1] World Bank, *Ethiopia Economic Update II: Laying the Foundation for Achieving Middle Income Status*, 18 June 2013, p. xi.
[2] International Monetary Fund (IMF), "The Federal Democratic Republic of Ethiopia: 2013 Article IV Consultation," *IMF Country Report*, no. 13/308 (October 2013), p. 20 (data as of May 2013).
[3] World Bank, *Ethiopia Economic Update II*, p. 6.
[4] Traditional microfinance is supplemented by savings and credit cooperatives, but like the microfinance companies, the impact of cooperatives is insignificant in light of the size of Ethiopia's unbanked population. IMF, "The Federal Democratic Republic of Ethiopia: Selected Issues," *IMF Country Report*, no. 13/309 (October 2013), p. 14.
[5] Proclamation No. 626/2009: Micro Financing Business Proclamation, *Federal Negarit Gazette*, no. 33 (12 May 2009), p. 4703.
[6] IMF, "The Federal Democratic Republic of Ethiopia: Selected Issues," p. 13.
[7] IMF, "Federal Democratic Republic of Ethiopia: 2013 Article IV Consultation," p. 21.
[8] World Bank, *Ethiopia Economic Update II*, p. 41.
[9] Ibid.
[10] According to the IMF, 79 percent was allocated to the public sector in fiscal year 2012/13. IMF, "Federal Democratic Republic of Ethiopia: 2013 Article IV Consultation," p. 21.
[11] World Bank, *Ethiopia Economic Update II*, p. 6. The purchased bills have highly unattractive conditions, paying only a 3 percent rate of interest and having a five-year term, effectively inflicting a loss on the banks when compared with the return available on business loans.
[12] Kozo Kiyota, Barbara Peitsch, and Robert Stern, "The Case for Financial Sector Liberalization in Ethiopia," *IPC Working Paper Series*, no. 29 (17 August 2007), p. 14, http://ipc.umich.edu/working-papers/pdfs/ipc-29-kiyota,peitsch,stern,case-for-financial-sector-liberalization-ethiopia.pdf.
[13] See ibid.; John P. Bonin, Iftekhar Hasan, and Paul Wachtel, "Privatization Matters: Bank Efficiency in Transition Countries," *Journal of Banking and Finance* 29, nos. 8–9 (August–September 2005): 2155–2178; Narjess Boubakri et al., "Privatization and Bank Performance in Developing Countries," *Journal of Banking and Finance* 29, nos. 8–9 (August–September 2005): 2015–2041; George R.G. Clarke, Robert Cull, and Mary M. Shirley, "Bank Privatization in Developing Countries: A Summary of Lessons and Findings," *Journal of Banking and Finance* 29, nos. 8–9 (August–September 2005): 1905–1930.
[14] Frederic S. Mishkin, "Is Financial Globalization Beneficial?" *Journal of Money, Credit and Banking* 39, nos. 2–3 (March–April 2007): 287.
[15] IMF, "Federal Democratic Republic of Ethiopia: 2013 Article IV Consultation," p. 6.
[16] World Bank, *Ethiopia Economic Update II*, p. 5.
[17] The Financial Action Task Force (FATF) pays particular attention to the prevalence and control of informal finance networks. FATF, *International Standards on Combating Money Laundering and Financing of Terrorism and Proliferation: The FATF Recommendations*, February 2012, http://www.fatf-gafi.org/media/fatf/documents/recommendations/pdfs/FATF_Recommendations.pdf (Recommendations 14 and 16); FATF, *The Role of Hawala and Other Similar Service Providers in Money Laundering and Terrorist Financing*, October 2013, http://www.fatf-gafi.org/media/fatf/documents/reports/Role-of-hawala-and-similar-in-ml-tf.pdf.
[18] Proclamation No. 780/2013: A Proclamation on Prevention and Suppression of Money Laundering and Financing of Terrorism, *Federal Negarit Gazette*, no. 25 (4 February 2013), p. 6755.
[19] African Development Bank Group (ADBG), *Federal Democratic Republic of Ethiopia: Country Strategy Paper 2011–2015*, April 2011, p. 12, http://www.afdb.org/fileadmin/uploads/afdb/Documents/Project-and-Operations/Ethiopia-2011-2015%20CSP%20ENG1.pdf.
[20] World Bank, *Ethiopia Economic Update II*, p. 14.
[21] According to the World Bank, Ethiopia's savings rate is "substantially lower" than expected and has declined over the past 10 years. Ibid., p. xii.
[22] ADBG, *Federal Democratic Republic of Ethiopia*, p. 6.
[23] World Bank, *Ethiopia Economic Update II*, p. 14.

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Acknowledgments

The Global Center on Cooperative Security commissioned this policy brief under the auspices of a 17-month capacity-building and technical assistance project titled "Strengthening Anti-Money Laundering and Countering the Financing of Terrorism Capacities in Ethiopia." The author is grateful to Liat Shetret and Tracey Durner of the Global Center for their feedback and contributions to earlier drafts of this brief. The Global Center is grateful to the government of Denmark for its support of this ongoing program.

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129 S. Main Street, Ste. 1, Goshen, IN 46526, USA
Design: Cutting Edge Design
Suggested citation: Tom Keatinge, "The Role of Public and Private Sector Banking in Ethiopia's Future Economic Growth," Global Center on Cooperative Security, September 2014.

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