Stretching out to Reach the Potential to Mobilize Domestic Financial Resources of African Low Income Economies: Case Study of Ethiopia

By

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List of Acronyms

DD	Demand Deposits
DRM	Domestic resource mobilization
ECA	Economic Commission for Africa, United Nations
ECSA	Ethiopian Central Statistics Agency
ERM	External resource mobilization
GDP	Gross domestic product
HDR	Human Development Report, UNIDO annual reports on human resource
I	Investment
IMF	International Monetary Fund
MFI	Micro financing Institutions
MDGs	Millennium development Goals
MoFED	Ministry of Finance and Economic Development, Federal Republic of Ethiopia
NBE	National Bank of Ethiopia, the central bank of the country,
NBFI	Non banking finance institutions
NSI	North-South Institute
NGO	Non-governmental Organization
ODA	Overseas development assistance,
S	Saving
SD	Saving Deposits
SSA	Sub Sahara Africa
TD	Total Deposits
UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Program

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Executive Summary

Despite the disheartening structural constraints of the Ethiopian economy, the recent growth episode and poverty reduction are lights of hope into the future. However, there is this challenge of ensuring sustainability of the recent experience and if possible to enhance it further.

The level of domestic saving has been quite low, leaving the sustainability of the recent encouraging growth history vulnerable to the availability, access and conditionalties of external resources.

Despite the different types of structural impediments, there is wide opportunity to enhance domestic saving. There are a number of institutional constrains that has been inhibiting the country from attaining the achievable in mobilizing domestic financial resources. These institutional constraints are amenable to change, if there is will and commitment to develop the necessary institutional and organizational capacity of both tax collection and financial institutions.

In general, the tax effort of the country has been very low. Taking inter period/regime/ comparison, Ethiopia's tax effort has been not only low but decreased in the recent past years. The tax effort was expected to improve given the fact that the post-1992 growth performance is by far greater than the pre-1992 period. In fact, the average growth rate of the pre-1992 was negative against a population growth rate of about 3%. The average growth of 1995-2000 was about 3% and the growth rates of the recent period since 2004 were double digit, greater than 10%.

Particularly the performance of direct taxes has been low throughout. Out of the total direct taxes, the contribution of business profit taxes remained very low without any visible trend of improvement. Despite the rapidly increasing resource flow to the private sector, in terms of credit and tax exemptions, business profit tax has remained low.

The contribution of the largest sector, agriculture has remained marginal throughout for long period of time. It has rather decreased in the recent past. In view of the fact that the sector still remains dominated by subsistence farming, though it might be difficult to expect substantial improvement of this tax, its contribution should have improved over time, as it is also a beneficiary of the recent growth process.

There has been substantial tax exemption, meant to encourage investment. The government's attempt to encourage investment is commendable. But it is timely to undertake an impact analysis of such instrument. Though there should be time lag, given the fact that investment has been increasing since 1992, it should have a positive impact on government tax revenue at this point in time.

Illegal trade has remained a serious problem in the country. In fact there are widely known corridors of illegal trade, the main being the Easter part of the country, mainly the Somali Regional State of Ethiopia. The problem of illegal trade is complex that calls for development intervention to curb illegal trade in that corridor. For significantly large part of the people illegal trade has remained as the single important source of livelihood. So curbing this illegal trade requires changing the source of livelihood of these people. In addition to such development endeavors to diversify livelihood of the needy agents of illegal trade, the government should strengthen its institutional capacity to control or at least minimize illegal trade.

These observations suggest the fact that it is timely to examine the tax system, which may cover the rates, identification of tax payers, tax assessment and collection system. One possible explanation for low and decreasing tax effort is high tax evasion, which may be attributed to corruption and low organizational capacity of the tax administration of the country. There is encouraging tax reform effort, but it needs to be further strengthened and that should be sustainable. In general, increasing tax collection efficiency and strong measures against illegal trade could increase the tax effort substantially in the near future.

Concerning pension the recent initiative to administer the fund independently as an autonomous entity is commendable. There are concerns that the present pension rate of

the civil servants of 10% is not adequate to ensure social security of the elderly. Moreover, much remains to be done to ensure compulsory pension system including the private sector. These improvements will bring about substantial increase of the pension fund. Yet, unless it is properly administered, it will remain used inefficiently. So far there are narrow opportunities for investment of pension funds due to the absence of capital market in the country. The development of the financial sector in terms of diversifying its services and the development of capital market focusing on bond markets and secondary markets provide wider opportunity for pension funds.

There are large Ethiopian migrants living in different parts of the world. So remittance remains one source of domestic financial resource mobilization, which can and should be tapped. Developing different saving instruments could increase saving out of remitted money. The fact that the NBE(central bank of the country) has allowed for opening up of foreign account at this time is commendable to motivate the Diaspora to invest and remit money to the country. Utmost effort should be exerted to encourage investment of the remitted funds.

There are study results that show the fact that SSA, among which Ethiopia is on, is indeed, net creditor owing to high capital flight. The direction should be to address the very incentive to save and invest abroad. This requires ensuring continual macroeconomic stability and sustainable peace and stability. It is timely for undertaking dedicated research to further understand the underlying causes and mechanisms of capital flight from the country.

One of the major factors that have been hindering full mobilization of domestic saving in general and private saving in particular is the embryonic stage of the financial sector, which is supposed to play a critical role in mobilizing private saving. It remained stunted for long except for the recent years. The country is under-banked with limited outreach. The banking sector provides the traditional banking instruments only. There is no capital market so far, which could have substantially contributed to attract savings and efficient allocation of investment.

There has been low effort to mobilize saving. There has never been any change in the instruments of saving, except saving and time deposits. Reflecting on the experience of the East Asian countries and others, it would have been possible to introduce different saving instruments. The banking sector could have been aggressive to boost savings. So far, low saving is not a reported problem of the country's banking sector. Indeed, in view of the excess liquidity and reserve of the sector, there cannot be an immediate interest to aggressively mobilize private saving. Thus, there has been simultaneously excess reserve and liquidity in the Ethiopian banking industry on the one hand and persistent and substantial macro-level short fall of saving on the other hand. Excessive liquidity implies the fact that the already small saving is being held idle. The economy desperately needs investment and yet there is idle money in the banks. It is like you are thirsty for water and there is water on the table and yet you cannot quench yourself.

The strategic directions should therefore be to make aggressive effort to mobilize saving using existing and new saving instruments on the one hand and reduce excess liquidity of the banking sector.

In order to increase saving, governments should pursue different strategies. One could be awareness creation to minimize expensive festivals, marriage and mourning ceremonies. The government may bring about different non-government forces mainly religious organizations to enhance saving consciousness of the public. This is so because amidst poverty there is extravagant festive culture in the country.

Moreover, the financial sector should develop alternative markets and instruments that can enhance saving and investment. Gradual introduction of capital market, which may start from government bonds appears timely.

In such an attempt to develop the financial sector, there is a need for developing innovative instruments to blend the formal with the informal financial institutions. There are quite important informal financial institutions that have to be integrated with the formal sector, which could be a win-win scenario for both types of financial institutions.

There is good size of credit market that is not being captured by the formal financial market. There are legally and illegally operating financial markets, where the formal markets were oblivious to the informal sector so far. The appreciation of the need to recognize and think of unconventional institutional mechanisms to mobilize these informal sectors could enhance saving.

The majority of the population is living in rural Ethiopia, a sector where there is at best very limited access to financial institutions. To complement the micro financing institutions, there is a need for institutional innovation to mobilize saving from the majority of the small farmer and urban poor. No matter of the magnitude of saving capability of these people, the mere size of the population warrants for innovative measures to effectively reach it. The financial sector has to develop saving instruments which are effective to reach the poor farmer but at the same time with lower transaction cost.

On the other hand, the central bank of the country should identify the underlying causes for over liquidity in the banking sector and promote credit and investment in the country.

One strategic direction is to develop the institutional capacity of the financial sector, where there is a modest beginning. The country needs to be more aggressive to invest on relevant capacity building areas to mitigate the bottlenecks that hinder smooth operation of the credit market, credit information, ensuring rule of law and minimize the chances for default.

Strengthening the monitoring and supervision and well-developed system of accountability is another avenue for improvement.

Figure 13: DRM Matrix: A summary of prospects and constraints of domestic financial resource mobilization

DRM elements	Constraints	Prospects
Domestic financial resource mobilization	Structural constraints	Recent growth episodes and poverty reduction from about 44% to 39% Major infrastructural works in the last decade; education, health, road, power, telecommunication
Low tax effort	Ineffective & inefficient tax collection	Recognition of the problem of low tax

	system	effort
	Corruption	An ongoing tax payers identification
	High tax evasion	Reorganization of the tax collection organization outside the civil service system, higher salary scale
	Low identification of taxpayers	Business process reengineering (BPR) and studies to introduce business score card
	Low tax assessment capacity	
	Low tax administration: delays	
	High tax exemption	Investment has increased though not accompanied by an improvement in tax effort
	Porous border & illegal trade	
Pension	Rate, coverage, pension fund use and allocation: No universal coverage, particularly not yet introduced in the private sector, low rates, narrow investment opportunities	After long period of procrastinations, independently organized, Initiations to establish capital market,
Remittance	Less leverage to determine outcome, affected by international shocks, challenge to convert it to productive allocation,	Increasing flow of remittances, Large size of Diaspora
Capital flight	Sources and mechanisms of capital flight less known Preliminary indicators it is a serious problem	Minimizing it could save substantial resources
Private saving/financial sector development	Low out reach of banks, under banked	An ongoing Studies by NBE to establish capital markets
	Low saving effort	An ongoing project to establish institutional capacity of the sector: credit register database,
	Excess liquidity Vs low saving	
	No capital market	
	Moneylenders	
	No attempt to integrate the informal financial institutions into the formal financial institutions	

1. Background

This background material includes four subsections. The first subsection introduces the paper and outlines the objectives of the study. This is followed by discussion on the saving-investment gap for Ethiopia. The subsequent subsection outlines the structural determinants of saving in Ethiopia. The fourth subsection briefly assesses the experience of East Asian countries.

1.1 Introduction

Ethiopia the second populated country in Africa with a population of about 75 millions is one of the low income Sub Sahara African countries, a country that has been exemplary of poverty for number of decades. A country with grave development deficit in literarily every sector of the economy needs huge financial resources. In order to achieve the MDGs, "it is reckoned that African and other low-income countries must, on the average, grow at 8% per annum for the period" calling for a huge investment, to the tune of 25% of GDP" (UNCTAD, 2000).

Given such resource deficit, the pertinent question is how to mobilize the required resources? The strategic directions include enhancing domestic resource mobilization (DRM)[2], external resource mobilization (ERM)[3], efficient resource utilization and a blend of the three strategic directions.

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[2] Domestic resource is defined here for the present study, non-debt bearing local resources, including both formal and informal domestic saving as well as remittances.

[3] External resource is defined here to include official development assistance (ODA), foreign borrowing and foreign direct investment (FDI).

For Ethiopia, at least for the short- and medium-run period, the three directions are not options to choose from; rather, the country will have to exploit every potential source. Given the initial situation, domestic and external finance cannot be substitutes to each other in the short- and medium- runs, as little has been achieved to-date to mobilize domestic resources. Particularly, in both the short- and medium- terms, Ethiopia will have to depend upon external finance to narrow down the resource gap that it has been encountering for long period of time. In the long-run, however, there are sound reasons for enhancing domestic resource mobilization and minimizing or ending with dependence on external financing[4].

The real strategic question and research problem of the present study, therefore, is how to enhance mobilization of domestic financial resource in Ethiopia? The objective of the study is, therefore, to examine the potential of Ethiopia to increase its total domestic financial resource envelope, in order to diversify their development resources and eventually reduce dependency on official development assistance and external loans. The study examines the prospects and constraints of mobilizing non-debt-creating domestic resources, with particular focus on domestic saving and its determinants. Since the financial sector is expected to play significant role in mobilizing private savings and allocate them to productive investment, the paper will assess the state of development of the financial sector, focusing on the depository banking sector of the country.

Though domestic resources could be broadly understood to mean, "anything and everything from domestic financial capital, to human capital, to social capital to natural resources (Culpeper and Bhushan, 2008:6), for the present study, it is defined as "fiscal and financial resources accruing within the domestic economy" (Culpeper and Bhushan, 2008:6).

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[4] There are arguments and data that show the external resources are not adequate to quench the thirsty for development resources. Moreover, there are concerns over the quality of the external resources.

Resource mobilization and hence saving comes at the center of domestic resource mobilization in less developed countries like Ethiopia. It is difficult to ensure sustainable development with low saving rate. In the absence of other sources, or volatility of external sources, unbearable conditionalties of external sources, low saving directly implies low investment, and hence low capital and knowledge content of production, which contributes to low productivity and hence low growth rate. With such resource gap, reaching the millennium development goals shall either be critically dependent upon external resources or it will be unachievable (Culpeper and Bhushan, 2008 and UNCTAD, 2007).

The rest of the paper is organized such that the next subsections of the section one will provide the background material. It will assess the nature of saving-investment gap, review of the structural determinants of such resource gap. The last subsection will make a succinct review of the experience of Far East Asian countries. The second section will assess public saving of Ethiopia focusing on tax revenue, pensions and remittances. In addition it will review the literature on capital flight. The third section discusses on the state of deepening of the financial sector and its implication to private saving.

1.2 The extent of investment-saving gap: State of domestic saving

This sub-section provides a brief review of the level and trend of domestic saving in Ethiopia.

Domestic saving has been low throughout the study period, since 1960. For the period 1961/62- 1993/94, both saving and investment were very low, which involves two policy regimes. Thereafter, with the introduction of the free market system since 1992/93, both saving and investment have picked up, but at different rates of growth. The average domestic saving and investment ratios to nominal GDP for the 48 years (1961/62-2008/09) were 12.8% and 19%, respectively. But these figures hide substantial inter-regime differences.

For the period 1961/62 up to 1973/74, the average domestic saving ratio was about 22% while the investment ratio was 20%, slightly lower than saving ratio. This displays the fact that investment was low given the severe and profound development deficit of the then Ethiopia.

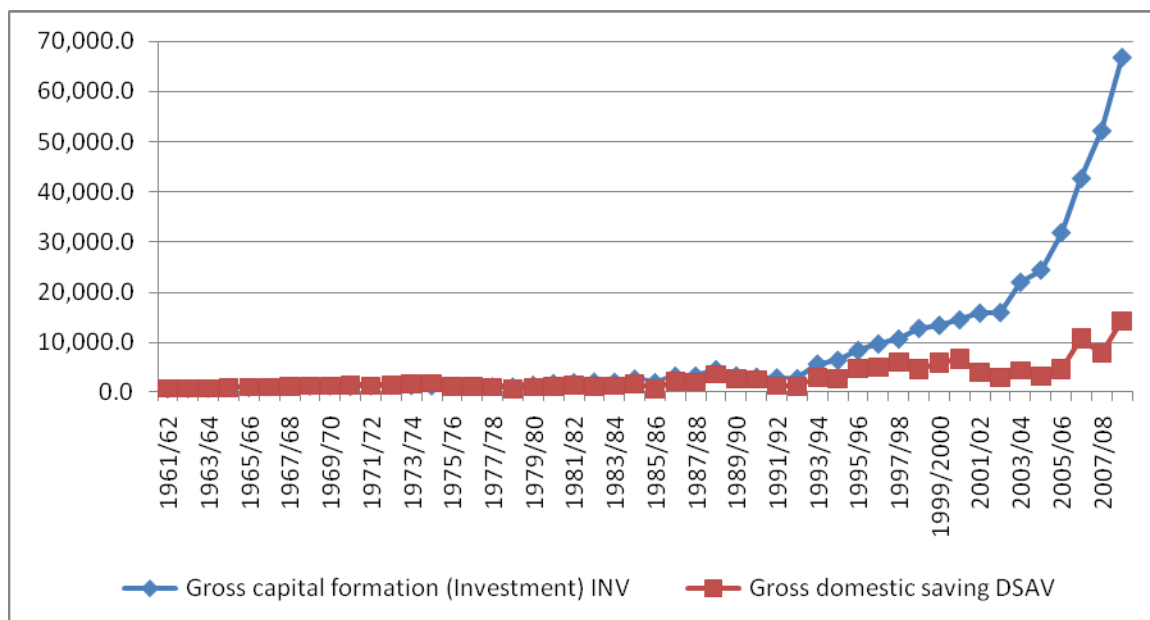
Table 1**:** Ethiopia's ratio of domestic saving and investment to nominal GDP (1961/62 - 2008/09)

Periodic Average	Average domestic saving ratio	Average investment ratio	Policy regimes
1961/62-2008/09	12.76	18.98	48 years average covering three policy regimes
1961/62-1973/74	21.9	20.0	Peaceful period, apparently free market system, under a feudal regime, the first instance of development endeavor
1974/75-1991/92	11.6	16.3	17 years; central command economy and less stable period, frequent war and conflict
1992/93-2008/09	6.9	21.1	16 years under the existing regime, free market system, private sector encouraged

Source: MoFED,

In the subsequent seventeen years (1974/75 to 1991/92) of central command economic management system, where the private sector was discriminated at a policy level, both average saving and investment ratios declined to about 12% and 16%, respectively. During this period, the performance of the Ethiopian economy was dismal due to policy problem, protracted civil war and inter-border war, which claimed large government expenditure, competing against capital expenditure in the non-war economy.

Figure 1: Ethiopia's Gross capital formation and Gross domestic saving (1961/62 - 2008/09)



Source: MoFED.

Although both investment and saving have increased substantially since 1992/93, the ratio of saving to GDP has declined to an average of about 7%, while the investment ratio has picked up to an average of 21%. Investment ratio has reached its maximum level of 25% in 2003/04, which, however, declined to about 23% in 2004/05. For the recent years, both saving and investment ratios have shown relative decline to about 4% and 20%, respectively, probably due to the double digit inflation of 2006/7-2008/09 and the impact of the current global crisis.

A slightly different data set helps to have a comparative perspective of Ethiopia's position against SSA average figures. Even by SSA standard, Ethiopia's rate of domestic saving has been very low. For the period 2003-08, the share of saving of the low income SSA countries was about 10% while that of Ethiopia it was about 4% only. As can be seen from the following table, for the period 1997-2010, the average saving rate of low income SSA was about 9% while it was about 19% for the middle income SSA countries.

For the same period the average saving rate of fragile SSA states was 11.5%, which is significantly higher than that of Ethiopia's average of less than 4%.

Table 2: Ethiopia's saving-investment gap (in percent of GDP)

	1997-2002	2003	2004	2005	2006	2007	2008	2009	2010
Ethiopia: Investment	17.1	21.6	25.5	23.0	24.2	25.0	21.8	19.1	16.4
Ethiopia Domestic Saving	6.6	3.6	5.0	3.0	3.7	5.6	0.6	2.1	0.3
Low income SSA saving	7.1	9.2	8.9	9.5	10.4	9.6	7.3	7.8	8.6
Middle income SSA saving	19.0	19.0	19.0	18.3	18.8	19.4	19.4	17.9	18.4
Fragile SSA saving	15.1	14.6	13.2	10.7	12.1	10.3	10.0	8.0	9.6

Source: International Monetary Fund (IMF), 2009: 72

If one looks into the investment and saving ratios of the recent years, investment is likely to decline to 19% and 16%, in 2009 and 2010, respectively, probably due to the impact of the global crisis.

In general, the rate of investment is low in view of the fact that there has been severe development deficit in the country. The investment ratio should have increased substantially, had it not been for short supply of finance. Throughout the last four decades since 1974/75, irrespective of differences in policy regimes, the critical bottleneck that has been constraining the investment rate has been the severe shortfall of savings.

Yet, this lower investment rate may not be sustainable. Sustainable development requires sustainable supply of development finance. With such persistent shortfall of domestic saving, the country will have to depend upon external sources of finance. This is a serious resource gap that leaves the sustainability of Ethiopian investment vulnerable to availability and conditionalties of external finance.

1.3 Structural determinants of domestic saving in Ethiopia

From the above discussion, one understands the glaring fact of severe resource gap that persisted for long period of time. In an attempt to explain this severe shortfall of saving, the present section briefly outlines the structural determinants of domestic saving.

Saving in general and domestic saving in particular is determined by a number of factors. Countries have different capacities to mobilize financial resources, owing to their differences in their level of development, level of income and its growth, structure of the economy, population growth and its dependency ratio, institutional capacity and system of governance, the development of the private sector, the level of development of the financial sector, trade openness and the degree of monetization, urbanization, and communication. Moreover macroeconomic policy framework including interest rate and inflation do determine the level and trend of saving of a given country. The culture of a country and political stability are also important determinants of saving and investment.

Some of these factors are structural that define the scope of financial resource mobilization, including public and private saving. These are structural constraints that call for structural transformation of an economy. The other group are policy variables, governance and institutional capacity of a country, which are more amenable to enhancing resource mobilization capacity of a country. The latter will be discussed in the subsequent sections of the present paper. In the present subsection, we briefly discuss the structural factors including macroeconomic context of financial resource mobilization.

1.3.1 Extensive and expensive festive culture in the midst of poverty

The consumption culture of a society is one determinant of domestic saving. It is difficult to generalize about the Ethiopian culture, in view of the fact that Ethiopia is a multi-ethnic and multi-religion society.

Yet, it may suffice to state the obvious fact that Ethiopian festivals are usually very expensive. There are many officially recognized religious festivals that claim huge resource for an Ethiopian household. For instance a brief view of the Ethiopian calendars

of any year shows the fact that there are 9 religious days for both the Christian and Muslim religions. In addition to the many officially celebrated days, there are more celebrated festive days at household and community levels.

Moreover, wedding and mourning celebrations are expensive in Ethiopia. These religious and social festivals are usually extensive and expensive to celebrate. Many visitors, which may extend to hundreds of people, are invited. Every visitor is generously served with food and drinks. There may be quite expensive ceremonies and formalities that one has to go through, consuming quite large resources.

The challenge with such type of expenditure is the difficulty to transform the cultural and/or religious value system. It may require the government to call upon the religious organizations, mainly Orthodox Christian church and Muslim, on board to play a critical role to bring transformation in the value system of the society.

1.3.2 Population dependency ratio

One of the determinant factors of domestic resource mobilization is the size of the active age population. Given income and other things, the larger the size of the working population the larger the potential for mobilizing domestic financial resources.

Though the Ethiopian population has grown up from the order of 25 million in the 1960s to nearly 75 million in 2009, the dependency ratio of the Ethiopian population has remained very high, with the pre-dominance of the younger generation. The share of the young and old age groups was about 53% in 1984 which showed only a slight improvement in the subsequent censuses of 1994 and 2007. As of 2007 the dependency ratio stands at 48%, meaning it is only 52% of the population that can be classified as working age group, which may contribute to the national GDP and hence to domestic saving(ECSA). From this active age population, discounting of open and hidden unemployment will reduce the size of the active age population which is actually engaged in to contribute to the domestic saving.

1.3.3 Ethiopia's dismal growth history and high absolute poverty

One essential determinant of saving is the ability and will to postpone current consumption. The level of income and the growth history of a country determine the overall capacity and scope for saving of a given economy.

The growth history of the country has been dismal by any standard except the recent six years or so. According to Geda, the average growth rate of four decades from 1960 to 2000 was only 0.73, but with large inter-regime differences. During the 1960-1974, the average annual growth rate was about 2% while the Ethiopian population had been growing for more than 3%.

During the 1975-1994, the Ethiopian economy had been declining on average at -0.8% per year, while the population was growing at nearly 3% (Geda, 2005:12). This average negative growth rate implies that these years were lost years in the development history of the country.

However, the growth history appears to improve since 1995. For the period, 1995-2000, the average annual growth rate had been 2.96%, while the average annual population growth rate was about the same, 2.9%.

According to other sources, the average real GDP growth rate of the period 1997-2002 was 3.4%. The average growth rate of per capita GDP of the same period was only 0.4%. In the year 2003, there were negative growth rate of -3.5%. The performance of the Ethiopian economy for these periods although it has exhibited recovery from the previous period, it was lower than the growth experienced by low income SSA countries. In the recent years of 2004-2008 the average growth rate was impressive by Sub Sahara Africa (SSA) standard. The growth performance of Ethiopia for the years 2004 to 2010 was impressive with 9.8%, 12.6%, 11.5%, 11.5%, 11.6%, 6.5% and 6.5%, respectively. For the period since 2005, it was even higher than the average of the Oil producing SSA countries (International Monetary Fund (IMF), 2009: 96). IMF's prediction shows the fact that the growth rate of the Ethiopian economy will slow down to 6.5% during 2009

and 2010 from double-digit figures of the 2004-08 years. MoFED's preliminary estimate of annual GDP growth rate of 2009 is above 9%. Even taking the lowest IMF estimate, leaves Ethiopia in a better position against all SSA averages (International Monetary Fund (IMF), 2009: 96).

One of the manifestations of the dismal growth history of the country is the prevalence of massive poverty. Poverty has been the principal economic, social and even political problem of Ethiopia for couple of decades. The magnitude of the population living below the absolute poverty line, though it has shown a modest reduction recently from 46% in 1995-96, to 44.2% in 1999-00 and 39% in 2004/05, is still a core problems of the country (MoFED, 2006: 27). Moreover, Ethiopia's per capita income, which was $180 in 2006, remains one of the lowest in the world (WDR, 2008) and sets the limit for saving mobilization.

The recent growth episode and poverty reduction if sustained is a signal of hope into the future.

1.3.4 Rain-fed subsistence agriculture economy with large informal sector

One structural determinant of DRM and specifically saving is the structure of the economy. Agriculture remains the main stay of the Ethiopian economy with about 46% share of GDP in 2006/07, employing nearly 80% of the labor force of the country. Yet the agricultural sector has essentially been subsistence and rain-fed one with little modernization and negligible share of irrigated agriculture. Throughout, the share of industrial sector remained less than 14% of GDP and employing about 6% of the labor force (NBE, Annual Report 2006/07: 5).

These are, however, figures that represent the formal sector of the Ethiopian economy. There is very large informal sector, which has not been captured by the system of national accounts. In low income countries like Ethiopia, the informal economy has evoked substantial attention by both academic and policy circles. This is so because there is a belief that it is very large. This part of the economy though significantly large

operates out of the public space. This sector is neither beneficiary from the public policies nor does it discharge its responsibility like paying taxes. In effect, the government macroeconomic policies, monetary and fiscal policies are largely not effective instruments to capture and shape the sector. It has remained very challenging to levy taxes from this sector. Moreover, the financial sector could not reach it to attract saving and allocate credit to encourage investment.

The informal economy involves both illegal and quasi-legal operators. Those illegal operators are business people who have the financial and organizational capability to operate beyond the law. These operators illegally import or export goods into and from the country. These people may have large production facility without trade license. Or they may operate beyond the capacity and area that they are licensed. Major feature of these operators is the fact that they are consciously beating the laws of the country.

In terms of illegal trading the borders of the country could be considered porous. Particularly, the Eastern part of the country, mainly the Somali regional state has been the main corridor for substantial illegal trading. So eliminating this sector calls for establishing strong institutional capacity to ensure prevalence of law across the board and transforming the lives of people and provide them alternative source of livelihood of the people who have been supporting themselves on illegal trading.

The other group of the informal sector is the quasi-legal sector which operates in all parts of the economy across the country. These operators are not strictly legal because they are not licensed. They do not pay taxes. Indeed they are beyond the scope of the public sector. Yet they are not illegal. These are micro enterprises which operate publicly without any treat of being illegal. They recognize themselves as legal but poor. The issue at hand here is the fact that these operators are low income earners, probably living below the absolute poverty line. They are not tax payers because they cannot pay taxes. Thus the challenge is to transform and develop them such that they become at least middle income earners, which could be subjected to taxation.

So one of the strategic directions of economies should be to devise effective mechanisms to incorporate the informal sector and bring it within the realms of public policy.

1.3.5 Macroeconomic imbalances: Current account balance and foreign exchange supply

Another dimension of the structural bottlenecks of the Ethiopian economy is related to external balance, specifically the trade and current account balances. The country's trade balance taken as a share of GDP was –12.8%, -17.1%, -19.8%, -22.6%, -23.7%, -20.3% and –20.6% for the years 1997-2002, 2003, 2004, 2005, 2006, 2007, and 2008, respectively, with a simple average of about -21 % of GDP(IMF, 2009:82-85).

The underlying cause of such deficit is the fact that the export sector of the Ethiopian economy is weak, specifically a mono-agricultural commodity with low diversification. Coffee remained the single most important exportable product for long period. While the share of coffee exports constituted nearly 70% in 1997/98 it declined to about 41% in 2004/05. Yet, the decline in the share of coffee exports has been due to a modest increase in the exports of other agricultural products like hides and skin, oil seeds and pulses (MoFED, 2005: 42).

Despite the fact that the last few years were the good years in terms of growth and MDGs achievement, there is still substantial gap between the actual performance and the planned targets of the MDGs, calling for huge resource towards achieving them. Thus one of the strategic directions of low income countries such as Ethiopia should be to enhance the mobilization domestic financial resources to close or narrow down the saving-investment gap.

In view of this direction, the following sub section makes a brief review of the experience of successful East Asian countries.

1.4 What can we learn from the miraculous growth of East Asian countries?

One of the major explanations of the East Asian miraculous growth was the very high saving rate which extended for an extended period of time. Recognizing this basic feature of their growth history, the major research question had been to explain as to why saving was particularly high in these countries? (Stiglitz, 1996:152; Stiglitz E. J, 2001:510)

There was high government intervention develop the financial sector and with the aim of increasing saving mobilization. The prime motivating factor of governments of these economies was to see improving performance of the financial markets and institutions. Specifically these governments have worked out to create and regulate financial markets and institutions with the prime objective of mobilizing savings and allocate them to enhance domestic investment *(Stiglitz and Uy, 1996: 249-250)* .

Governments of these countries have used different instruments and strategies to increase savings. For some governments (Singapore and Taiwan, China), public sector savings was high while in others private savings was high. For instance "Malaysia and Singapore guaranteed high minimum private saving rates through mandatory provident fund contributions (The World Bank, 1993:*22).*

East Asian governments have used different strategies to increase savings. Their interventions to boost savings are summarized as follows. For details one may read (The World Bank, 1993:*22 and Stiglitz and Uy, 1996:* 251*).*

1. They promoted saving education using different strategies including saving mobilization campaigns,

2. They have created postal savings, which attracted large number of small savers. This instrument reduced transaction costs and mitigated risk. The postal saving instruments opened up wide access to large part of their populations, covering the entire postal branch network of their respective economies. These become instrumental to outreach rural areas. Some countries encouraged postal saving by

providing exemptions of taxes on interest earning from such deposits. Moreover, they have introduced saving bonds, youth saving schemes and related others saving instruments.

3. These governments have made contributory pension system universal and compulsory to all sectors of the economy. To avoid social crises at latter years of life and free-riders problem, governments made it compulsory for a minimum level of saving for retirements. This covered all types of employment.
4. One more strategy used to encourage saving was to regulate the financial sector with the prime objective of its development and healthy operation. The development of a healthy and safe financial sector is instrumental to increase saving and ensure their efficient allocation.
5. Many of these governments followed active policy to encourage saving and discourage credit allocation for consumer items. They pursued stiff taxes on luxury consumption.
6. Most governments of these economies pursued moderate financial restraints. They controlled deposit and lending rates below market levels aiming at encouraging saving and its reallocation to investment in the economy.
7. In pursuing macroeconomic stability, these governments were running small fiscal deficits or even surpluses.
8. Maximum effort was done to outreach the small and rural savers.

Obviously, these cannot and should not be taken as formula. Low income countries like Ethiopia need to be innovative to adopt these and other instruments to increase domestic savings. It will be wise to consider the domestic realities, informal financial institutions, adequacy and capacity of the supervisory government organizations in introducing new instruments to encourage saving and strengthen existing strategies.

1. The State of Ethiopia's Domestic Revenue and its implications for Domestic Resource Mobilization

One major feature of the Ethiopian macroeconomic situation is the fact that there has been persistent fiscal deficit, as may be observed from the following table. Taking the period, 1997-2010, there have been persistent fiscal deficit. Even including grants, the country has been facing a fiscal deficit of about - 6% in the period 1997-2002, which then started to decline less than -4% of GDP since 2006. Understandably, excluding grants, the fiscal deficit is worsened, with a deficit of about -14% in 2003, which declined to less than -8% since 2007. IMF forecasts that fiscal deficit will be decreasing during 2009 and 2010, probably anticipating the government will follow tight fiscal policy, reducing government expenditure and local borrowing, following the inflationary situation during 2006-09 and the global crisis.

Table 3: Overall Fiscal Balance, Including Grants and Excluding Grants (% GDP)

Country, regional averages	1997-2002	2003	2004	2005	2006	2007	2008	2009	2010
Fiscal balance including grants – Ethiopia	-5.9	-7.0	-3.0	-4.4	-3.9	-3.6	-3.0	-1.5	-1.1
Fiscal balance excluding grants- Ethiopia	-9.0	-13.6	-7.6	-8.7	-7.4	-8.1	-7.2	-5.4	-4.3
Fiscal balance excluding grants Low income SSA	-7.2	-7.9	-7.5	-7.6	-7.8	-7.9	-7.9	-8.6	-7.9

Source: International Monetary Fund (IMF), 2009: 74

The Ethiopian fiscal deficit has been higher than the low income SSA countries. Ethiopia's fiscal deficit was higher than the low income SSA average for the period 1997-2005. Since 2006 the share of deficit to GDP has been slightly lower than the African average.

As to how to address this problem, one may consider both of the revenue and expenditure sides of the same coin. One strategic direction to follow is to increase government

revenue to ensure healthy macroeconomic position of the country, which will lead us to examine the state of government revenue, with particular focus to tax revenue.

Apart from the structural constraints which were briefly discussed in the preceding section, the overall institutional capacity and system of governance of the fiscal institutions determine public saving in general and the tax effort in particular.

The present section assesses the tax effort of Ethiopia. In doing so it discusses the structure of revenue and tax revenue of the country. Moreover it reviews pensions and remittances as well as capital flight. The discussion on capital flight is entirely confined to a review of empirical research.

2.1 Tax structure

The Ethiopian tax system involves different types of direct and indirect taxes. This includes different types of income taxes, including employment (0-35%), profit and rental (35%), interest income (5%) taxes. Moreover a value added tax (VAT) of 15% was introduced since 2003 in lieu of sales tax. In addition, different tariffs are being charged on mainly import items.

One of the structural constraints of tax revenue of low income countries like Ethiopia is the fact that the taxable income is low owing to massive poverty, large informal sector, predominance of the subsistence agricultural sector as well as severe tax avoidance and evasion.

As can be seen from the following table, in the period 1979/80-2007/08, the average share of tax revenue from total revenue and grants has been about 60%, with slight inter-period/regime/ differences. The average share of tax revenue has declined from about 63% during 1979/80-1991/92 to about 58% during 1992/93-2007/08.

One of the outcomes of low tax bases is the fact that the share of direct taxes is low. In the entire period of about 30 years (1979/80-2007/08), direct taxes constituted only 37% of tax revenue. Despite expectation, the share of direct taxes has declined from about 40% in the period 1979/80-1991/92 to about 34% during the subsequent period of 1992/93-2007/08.

Table 4: The Structure of Ethiopia's Public Revenue for 1979/80-2007/08(in Percent)

Revenue Items	1979/80-2007/08	1979/80-1991/92	1992/93-2007/08
Share of tax revenue of total revenue & grants	60.38	62.74	58.46
Share of Direct taxes of total tax revenue in %	37.04	40.28	34.40
Share of personal income of direct taxes	27.71	27.75	27.68
Share of Business Profits of direct taxes	54.46	56.92	52.47
Share of agriculture tax of total direct tax	10.79	13.73	8.41
Share of Indirect taxes & Duties from total tax revenue	62.96	59.72	65.60
Share of domestic indirect taxes from tax revenue	26.36	30.75	22.79
Share of external indirect taxes of total indirect taxes	57.61	48.22	65.23
Share of tax revenue of total domestic revenue	71.73	72.42	71.18
Share of non-tax revenue from total revenues	28.27	27.58	28.82
Share of external grants from total revenues & grants	15.73	13.48	17.55

Source: MoFED

The share of direct taxes was expected to increase following the changes in policy from central command economic management system (where the private sector was discriminated) to free market economic management sector and the favorable growth experience in the latter period and a period when the private sector is being nurtured[5].

In the entire period of 1979/80-2007/08, personal income tax constitutes nearly 28% of the direct taxes in both policy regimes with no change in its relative position. The tax rate

[5] The later period was favorable to the private sector. There has not been any policy barrier against the government. In fact one of the pillar strategies of the present government is to promote private sector development. There has been favorable investment incentive system and the flow of credit to the private sector has shown a rapid increase, as can be seen from subsequent section on financial sector development.

was quite high (0-85%) during the previous policy regime, which was reduced to the range of 0-35%. Yet, following the federal arrangement and district level decentralization, the Ethiopian government bureaucracy should have increased substantially to contribute more to personal income tax. Moreover, there has been an increase in the private sector and NGOs which must have contributed to employment and personal income taxes. Despite this the relative share of personal income tax remained at about 28%. In Ethiopia, personal income tax is the type of tax with least tax evasion. The largest employer of the modern sector has been the government bureaucracy. As a result there has been little or no room for tax evasion.

On the other hand the share of business profit tax has remained at low level, slightly higher than 50% of direct taxes. This could be attributed to two factors. In view of the low level of development of the economy, and specifically the pre dominance of the rain fed based farmer-agriculture, it is a fact that the business community has been a nascent one. The economy has emerged from state-command economy, when the private sector was discriminated at policy level. The other possible reason could be large tax evasion by the business community. There has been a policy shift since 1991/92. Every basic policy reform was completed in the early 1990s. Since then the tax base was expected to expand and the share of direct taxes and particularly the share of business profit tax should have increased. At least, there has been double digit growth since 2004. The average growth rate of the period 1995-2003 was about 3%, slightly higher than the population growth rate and definitely significantly higher than the average of pre-1992 which was negative (-0.7%). As it is discussed in subsequent sections of the present paper, the resource flow to the private sector in terms of credit has shown a dramatic increase. With such developments, the share of business profit taxes should have shown significant increase.

Another important structural weakness of the Ethiopian tax system is the poor contribution of the agricultural sector, which is the source of livelihood of about 80% of the Ethiopian population and the largest contributor to both GDP and exports. The share of agriculture based taxes and fees, was only about 11% in the entire period of 1979/80-

2007/08, which has shown further decline since 1991/92 to about 8 %. Even during the last six years of consecutive growth of the agricultural sector, the tax contribution of the sector did not pick up, indicating that this tax has not been responsive to the growth of the sector. Frequent droughts and famine could have contributed to the low performance of the sector. But still, the contribution of the sector should have improved instead of showing a declining trend.

Thus the dominant contributor to tax revenue in Ethiopian has been indirect taxes, taxes levied on goods and services. The share of indirect taxes has been about 63%, 60% and 66% in the periods 1979/80-2007/08, 1979/80-1991/92, 1992/93-2007/08, respectively. Out of the total indirect taxes, taxes on imports and exports stand to be dominant contributor with about 58% of indirect taxes in the period 1979/80-2007/08. This tax, however, is vulnerable to the vagaries of international shocks like the 2007-09 global economic crises. Due to the global crises exports and external resource flow declined and hence the supply of foreign exchange has declined. The already scarce foreign exchange resource has become scarcer to the extent of forcing the central bank of the country to administratively allocate to priority imports. Scarcity of foreign exchange leads to a decrease in imports. So one of the effects of global crises on low income SSA countries like Ethiopia has been to reduce both exports and imports, which implies a decline on tax revenue levied from the imported and exported goods.

2.2 Tax effort

The performance of the tax revenue depends upon the tax base and the tax collection effort, which includes the tax rate, coverage, assessment and collection. The state of institutional and organizational capacity of the tax administration system in each aspect of the tax collection system determines the tax effort.

One indicator of tax effort is the ratio of tax revenue to GDP. Ethiopia’s tax effort has been low throughout the last four decades. Moreover, it rather appears to decline instead

of an increase. This can be seen using different indicators. The first indicator is to see into the inter-regime/ inter-period/ differences of the tax effort of the country.

There has not been significant change in the percentage share of revenues throughout the period, 1974/75-2007/08. The average ratio of revenue and grants to GDP remained at 19.2% with a decline for the latter period. It appears to decline from an average of 20% during 1974/75-1991/92 to about 18% during 1992/93-2007/08. Considering the recent years, it has declined from the order of 20% during 2003/04 to about 16% during 2007/08.

Table 5: Average share of government revenue to nominal GDP

Item	Average share to GDP			Annual share to GDP				
	1974/75 - 2007/08	1974/75 - 1991/92	1992/93 - 2007/08	2003/4	2004/5	2005/6	2006/7	2007/8
1. Total Revenue & Grants	19.2	20.2	18.1	20.4	18.9	17.7	17.1	16.2
1.1 Revenue	16.3	17.6	14.9	15.8	14.6	14.8	12.7	12.1
1.1.0 Tax revenue	**11.9**	**13.1**	**10.6**	**12.4**	**11.6**	**10.8**	**10.1**	**9.7**
1.1.1 non tax revenue	4.5	4.6	4.4	3.4	3.0	4.1	2.6	2.4
1.2. Grants	2.9	2.5	3.2	4.6	4.3	2.8	4.4	4.0

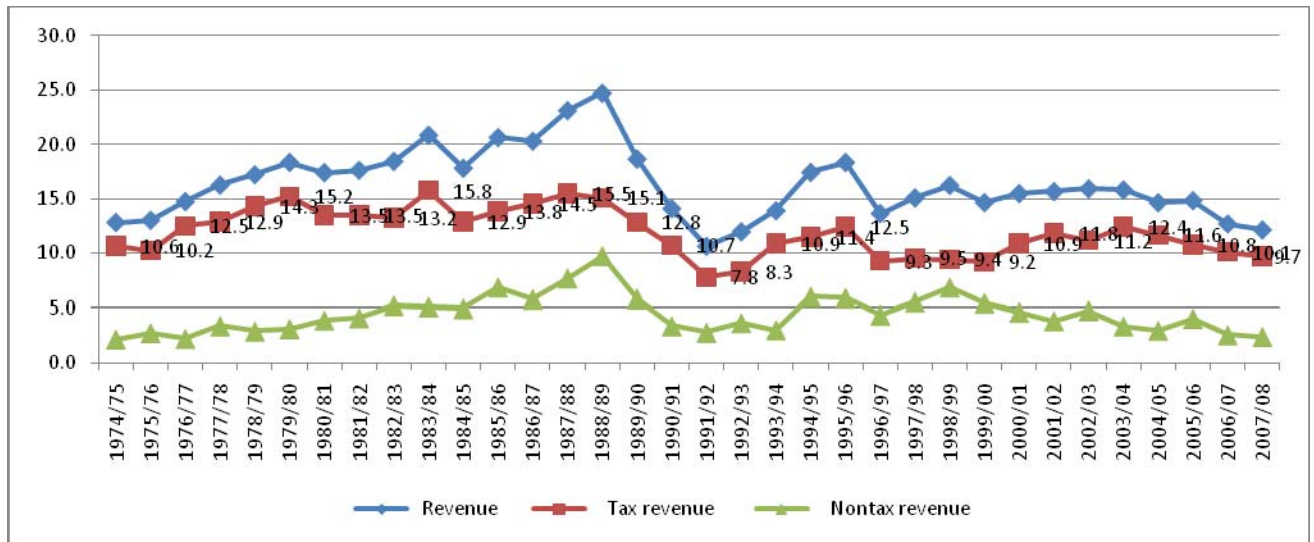
Source: MoFED,

Similarly, the share of revenue exhibits the same trend. On average revenue has been about 16.3%, 17.6% and 14.9% for the periods, 1974/75-2007/08, 1974/75-1991/92, and 1992/93-2007/08, respectively. Taking the recent period since 2003/04, it has declined from about 16% in 2003/04 to 12% in 2007/08.

This trend of the overall government revenue is governed by the principal source of government revenue, which is tax. So the trend of the government revenue is explained by the level of tax effort. Comparing the tax to GDP ratio, of the present regime against the previous regime, it has declined from 13.1% for the period 1974/75-1991/92 to 10.6% for the period 1991/92 - 2007/08. Moreover, taking the recent years, the share of tax revenue has declined from 12.4% in 2003/04 to 9.7% in 2007/08.

As may be read from the figure below, while the range of the share of tax revenue to GDP for the period 1974/75-1990/91 was 10%-16%, it declined to a range of 9% - 12.4% for the period 1994/95-2007/08.

Figure 2: Percentage share of revenue, tax and non tax revenue of nominal GDP, 1974/75-2007/08 (in percent)



Source: MoFED

The figure shows the fact that the tax effort of the present policy regime at its best and worst levels were lower than that of the previous policy regime.

Apparently, the tax rates of the previous regime were on the high side. For example, the income tax rates were reduced from 89% to 35% for private limited companies and for employment income tax it was reduced from 85% to 35%. This downward adjustment may partially explain the reduction of the tax ratio. Definitely, it would bring an immediate decline in the first five years or so. But the tax effort should have gradually picked up following the periodic growth rates of the Ethiopian GDP and related expansion of the private sector. Instead, the average tax effort should have picked up at least in the later years of the present policy regime. Rather it has shown a declining trend.

Moreover, one observes that the tax effort reaches its bottom level during the years of political takeover. The share of tax to GDP was particularly low during 1974/75 and 1991-1993, which can be attributed to low tax collection during the institutional discontinuity between two regimes, where power was taken over through non-peaceful manner.

The other indicator is inter-country comparison. Using different but related data set, one understands the fact that the tax effort of Ethiopia is low even by SSA standard.

Table 6: Government revenue of Sub Sahara Africa Countries 1997-2010 (in % of GDP)

Countries	1997-2002	2003	2004	2005	2006	2007	2008	2009	2010
Ethiopia	**15.1**	**16.2**	**16.1**	**14.6**	**14.8**	**12.8**	**12.5**	**12.5**	**12.5**
Low income SSA average	14.1	15.3	16.0	16.1	16.5	17.1	17.1	16.4	16.6
Fragile SSA average	13.5	13.8	14.6	15.2	16.1	16.8	17.7	17.3	17.6
Middle income SSA countries	24.5	24.2	24.8	26.2	27.2	27.6	27.0	26.6	26.5
SSA	21.1	20.8	22.3	24.1	24.7	24.0	24.7	20.8	21.6
Kenya	20.2	19.7	21.4	21.2	21.1	22.2	22.0	21.5	21.1
Ghana	15.4	20.2	22.4	21.8	21.9	22.7	22.8	22.4	22.3

Source: IMF 2009: 75

For the period 2005-2010 (of course the figures for 2009-2010 are estimates), the percentage share of revenue (both tax and non-tax revenue) to GDP of Ethiopia, has been consistently lower than the average of the low income SSA countries. Similarly, the share of Ethiopia's revenue has been consistently lower than the SSA average which was consistently higher than 21% in the given period, 1997-2010. Even comparing Ethiopia's performance against Ghana and Kenya, Ethiopia's revenue has been consistently lower than these two countries, which both are within the category of low income SSA countries.

In general, given the low and declining trend of tax effort, one may conclude the fact that there is wide room for increasing tax revenue in Ethiopia.

2.3 What are the major reasons for low tax effort in Ethiopia and what should be done?

Apart from the structural factors that have been constraining the tax effort of the country, the structure of the tax revenue itself is indicates the inherent limitation of tax revenue of the country.

As discussed above, the contribution of profit tax has been low despite the favorable growth and macroeconomic policy system which has been nurturing the private sector. This is one of the potential areas for increasing tax effort of the country. The contribution of the agricultural sector, has been on the low side, justifying for improving the effort to collect more from this sector.

The other reason for low tax effort is attributed to high exemptions[6]. There are some data that show the fact that tax foregone due to exemption has been substantially high and increasing over time.

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[6]One of the core objectives of the tax policy was to promote investment in the country. To this effect, one of the investment incentives of the country is tax exemption for the imports of capital goods, for both initial and replacement/rehabilitation investments. Moreover, there is tax holiday for the first five or so years of operation. These exemptions are meant to contribute to competitiveness of local firms in the global competitive environment. Furthermore, these policies aim to attract foreign direct investment (FDI) to the country.

Table 7: Revenue foregone with Customs Exemption (in millions of Birr)

Exemption items	2005		2006		2007	
	value	%	value	%	Value	%
Exemptions of capital goods imported by:						
*Private capital goods	1171.7	29.74	1610.9	34.71	2572.1	33.3
*public sector capital goods	984.2	24.98	730.9	15.75	2207.6	28.6
*NGOs Capital goods	95.7	2.43	110.4	2.38	112.4	1.5
exemptions of imports by private	240.5	**6.10**	289.9	6.25	297.7	3.9
Exemptions of personal effects	502.3	12.75	856.4	18.45	1096.7	14.2
Exemptions of Diplomatic community	334.2	8.48	368.2	7.93	476.1	6.2
Exemptions to professional trade	20.3	0.52	16.7	0.36	21.9	0.3
Exemption of raw materials to pharmaceuticals	8.7	0.22	11.9	0.26	13.8	0.2
Exemption of import by public enterprises	68.8	1.75	62	1.34	82.6	1.1
Industry specific exemptions	49.7	1.26	47.9	1.03	76.6	1.0
Others	464.4	11.79	536	11.55	761.6	9.9
Total revenue foregone	**3,940.5**	**100.0**	**4,641.2**	**100.0**	**7,719.1**	**100.0**
% share of GDP	**3.7**		**3.52**		**4.51**	

Source: Ministry of Revenue, 2008,

For the year 2008/09, the total exemptions were Birr 14.9 billion, constituting of 4.2% of GDP. Though for only few years the data from the Ministry of Revenue indicates, indeed, the size of foregone taxes due to exemptions is very large.

From the table, one notes that the largest beneficiary is the private sector. Indeed, given the existing free market policy framework, it is the private sector which is the target of such incentive system.

But why is that the resource flow to the private sector has been increasing while the ratio of tax to GDP has not been showing similar trends?[7] Here it is argued that it is more

[7] In subsequent section on credit flow to the private sector, we observe high and consistent increase. If we consider both credit and tax exemptions that has been channeled to boost investment in the country, and provided there has been growth of the GDP as discussed in the previous sections, the question as to why tax effort did not improve is a right question to ask for research.

likely to be tax evasion which could be partly explained by corruption in the system. The beneficiary of the tax exemption is the formal sector.

Moreover, this is a serious problem, in view of the fact that there has been quite large gap between investment registration rate and the investment implementation rate. Though there has not been formal study, some officials and experts indicate the fact that the implementation rate of investment does not exceed beyond 20% of the registered investment licenses.

What happens is that business persons start everything and proceed up to the point they get the tax exemptions to import capital goods and then they abuse this privilege and shift to other business ventures, without investing in the area they promised to invest. The requirements for getting the exemption privileges which include submission of investment license and a feasibility study are cheaper to comply. The investment study document is very preliminary study prepared at very small cost. The investment licensing is cheap, which is meant to encourage investment. So many business persons prepare these documents and meet the official requirements at very small expenses[8] and enjoy the exemption privileges to import many things including quite expensive cars that may not be required for the actual investment.

For instance the researcher understood that a local investor who registered for garment ended up in advertisement. Others failed to respond to the enquiries of the researcher, probably to avoid any risk of being identified by government authorities. Another local investor, who imported quite large office furniture, has sold them in the local market profiting in millions. There are even cases where expatriates who registered for FDI and became beneficiaries of the tax exemptions but who have been importing finished goods

[8] The researcher does not have the intention to imply that the investment licensing should be expensive and cumbersome. Rather, it is being argued that investment facilitation is being abused ending up with tax evasion that reaches up to about 5% of the GDP of the country.

and trading them in the local market, which was a clear abuse of the investment incentives. Such business persons bribe customs officers/officials/ and import non-exemption items without paying import taxes. They import in bigger quantities of exempted goods beyond what they need for their investment and sell the extra in the local market.

There could be time lag between the tax exemptions and the impact of these tax exemptions on actual investment and business tax revenue, but that investment lag cannot take ten years or so. This incentive system has prevailed for about two decades since 1992. The outcome of the high investment rates and exemption rates on tax revenue should have been experienced since the last ten years or so.

It will be difficult to suggest for giving up this investment incentives. In view of the nascence of the private sector, low investment rate in the country and different investment constraints, it may be justified to provide tax exemptions. This is a sacrifice the government has been willing to promote investment in the country. But it is timely to conduct impact assessment study and accordingly take corrective measure to at least mitigate the corruptive behavior in this area. At the same time, the government should take strong measures against the abuse of these tax exemptions.

The other factor that may explain low tax effort could be the low institutional capacity of the tax collection system, including both the tax collector and the tax payer. The tax collection has remained weaker in terms of organizational system, human resource development, motivation and corrupted behaviors.

The major constraint of the tax collection system is the fact that there is very poor tax assessment capacity in the country. Identification of tax payers is only a necessary condition for good tax collection. This identification of tax payers has to be complemented by tax assessment capacity of the tax payer and collect accordingly. However, this has remained challenging task in Ethiopia. For one thing there are quite large numbers of tax payers, who are sole proprietors, who do not have records of their

business. Even private limited liability companies, which are expected to have system of accounts and required to present audited financial reports have not developed such capacity. The auditing industry is also at its infancy to deliver to this expectation.

Following the recognition of the fact that it is difficult to expect financial records from small business owners, one type of tax in Ethiopia is presumptive taxation. This is meant to capture the hard-to-tax group because there has not been strong tax assessment that could have served for such taxation. Without tax assessment, presumptive taxes are more likely to remain arbitrary tax amounts, which may be dangerous. It is a curse if you understate your estimate and it is equally a curse if one overstates the tax as it may kill the egg-laying goose. For such tax to be effective there is a need for regular comprehensive profitability study across the different sectors of the economy. Such study could then be used to determine the tax rate.

This has been contributing to high tax evasion owing to corrupted behavior of some tax payers and collectors.

Moreover, one of the sectors which has been avoiding the taxation system is the contraband trade which operates illegally. These are people who have the capacity to outsmart the government. There has not been any quantitative study to determine its significance. Yet, there is an understanding that illegal trade is rampant and claiming away a lot tax revenue. There are different corridors of illegal trade. The major corridor is the Eastern part of the country bordering with Somalia. In this corridor, it is even difficult to control illegal trade. The livelihood of large population is based on this illegal trade. Unless measures are taken to transform the livelihood of this people, it appears difficult to effectively control of illegal trade in the Somali regional state in Ethiopia. The regional government cannot be fully committed to discourage illegal trading of different types of industrial goods, merely it recognizes the fact that very large part of its population depends upon this source of income. So administrative controlling of illegal trade will not be an effective means to control illegal trade. Rather diversifying the source

of livelihood should be the strategic direction to curb illegal trade and increase government revenue.

2.4 Tax reform

Since 1992, there have been major economic reforms involving liberalization and privatization policies that included major changes in the tax rates, from highly progressive towards a moderate level which aims to boost investment too.

Apart from the revision of the tax rates downward in the early 1990s, different reforms are being undertaken to increase tax effort of the country. Pronounced changes are those that are taking place since 2005 or so. Following the Public Sector Reform Program (PSCAP) tax reform was undertaken throughout the country.

The trust of the tax reform has been to create an efficient and effective tax collection system in the country, including creation of tax awareness of the public, identification of potential tax payers, business reengineering to improve the tax administration, minimize tax evasion and increase tax collection. In view of the low tax effort, these measures can enhance the tax collection capacity of the country.

In this regard, in the last seven years or so the tax administration has already developed computerized tax collection system, with the specific objective of indentifying and recording tax payers of the country. To this effect tax identification numbers are issued for every tax payer. This has been one of the major achievements in the last five years for a country which did not have the knowledge about the size and nature of its tax payers.

In view of identifying the tax payers, monitoring and eventually developing the data base for tax assessment, the tax collection system is introducing information and communication technology. It has started to introduce Standard Integrated Government Tax Administration System, SIGTAS, ASYCUDA ++, TIN and cash register system (Ministry of Revenue, 2008).

In view of enhancing tax revenue, a number of new taxes were introduced recently. For instance service sales, rental income and capital gain taxes were introduced in 1990, 1993 and 1994, respectively. Moreover, sales taxes were replaced by VAT in order to widen up its tax base since 2003.

Following the BPR exercise, the Ministry of Revenue, the Federal Inland Revenue Authority and the Ethiopian Customs Authority were merged into the Ethiopian Revenue and Customs Authority (ERCA) on July 2008.[9] The newly established authority is managed outside the civil service system, with the autonomy to fire and hire employees. Moreover it has introduced higher salary scale to attract competent staff and meant further to serve as a motivation not to involve in corrupted behaviors.

Why was that it did take so long to undertake business process reengineering and to seek autonomy? This is simply because, the civil service system of the country in general and the tax collection organizational set up in particular were not learning organizations. Somehow, the federal government has initiated the Public Sector Reform Program, of which tax reform has been one component, and hence the present initiative was taken. The initiative to undertake reform of the public sector is commendable provided it is effectively implemented.

Yet, the major challenge of the civil service system in general and the newly established revenue authority is to develop a learning organization, which has inherent capacity to generate a momentum of change. Institutional reform is not something that can be effectively implemented through campaign type changes in a given period of time. Rather

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[9] Before July 2008, there was Ministry of Revenue, Ethiopian Customs Authority, the Federal Inland Revenue Authority who were merged to create the newly established Ethiopian Revenue and Customs Authority (ERCA) on July, 2008. The objective is give autonomy to hire fire and pay outside the civil service system.

it has to develop the organizational capacity including the autonomy and culture of taking initiation to change over time.

A fixed salary increment might not take the authority too far. There are good arguments for developing performance-based management system. That is more likely to be inherently dynamic. This is, however, easier said than done. It requires strong performance data which can help to measure the contributions of each organizational unit and individual employees of the organization.

2.5 Pensions

Since pension is a deferred consumption, it can be treated as an element of domestic saving. As a saving element, the question is how to get it increased and ensure its efficient allocation to boost investment.

With developments over time, the proportion of the aged population is more likely to increase into the future. Unless social security is established, what will happen to those who are disabled to work and hence earn income? Inability to work and earn income to support oneself is and should be a social problem that calls for government attention.

Different countries have adopted different pension systems[10]. Those East Asian countries, who have taken off the development ladder, have treated pension contribution as instruments of national saving in their respective economies. As a result these countries have set high contribution rates (up to 50 percent of salaries in Singapore and 28 percent

[10] There are two broad options. One is the universal non-contributory social security/pension/ system to all elderly and other related segments of the society. This could be effective to address the problem as the government is bearing the burden of financing this service. The problem for Ethiopia is the capacity of governments to bear the fiscal burden of such pension system. The alternative is to go for contributory pension targeted to certain groups of elderly. This reduces the fiscal burden to the government but at the expense of ensuring universal coverage of problems of the elderly.

in Malaysia) and the fact that the savings covered not just retirement but other purposes as well, such as providing the down payment for housing (Stiglitz and Uy, 1996: 251).

For Ethiopia there are concerns and possibilities for an increase of pension funds. One concern is the fact that the Ethiopian pension system has partial coverage. It does not cover the private sector, which has not yet introduced it as a system. So the suggestion is for introducing mandatory pension system in the private and NGO sectors.

The current civil service's pension is based on employee contribution of 4% and government contribution of 6%. There are those who argue the fact that the existing pension rate of 10% is low, contributing to low pension income at later ages of the beneficiary.

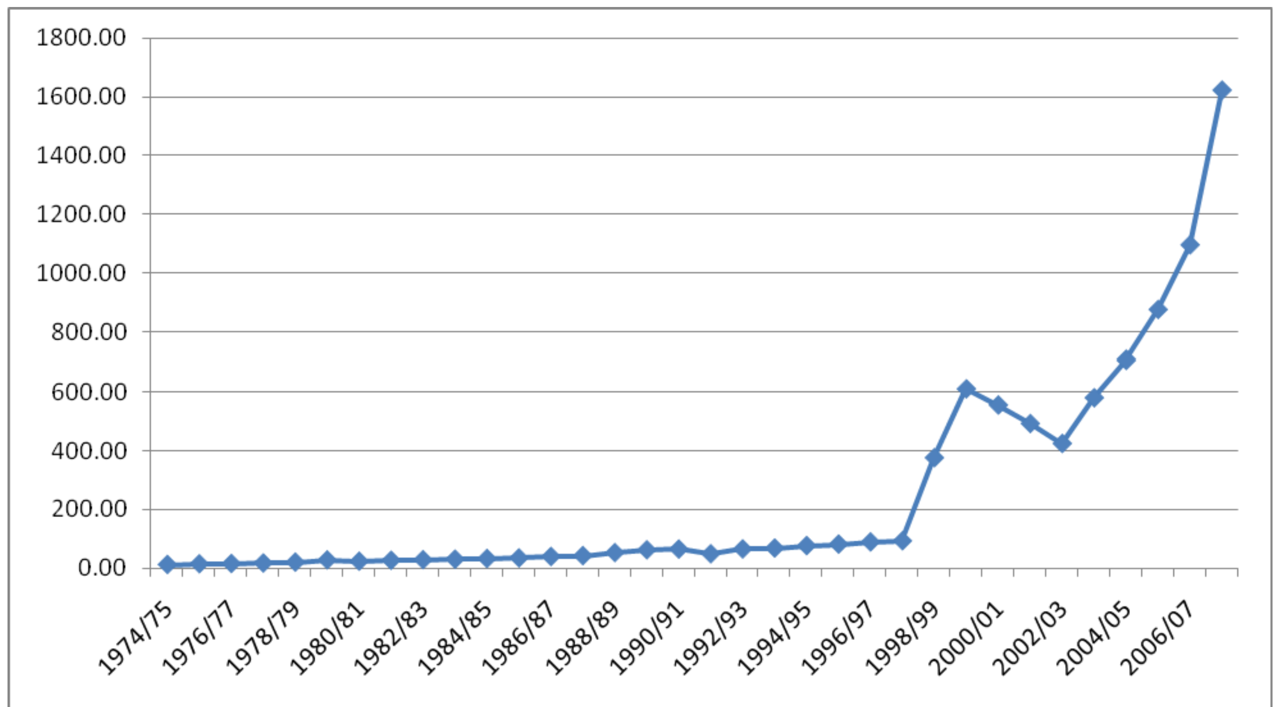
Despite the lower pension rate and partial coverage, pension has increased from the order of about Birr 11 million during 1979/80 to about 1.6 billion in 2007/08. The annual average growth rate for the period 1979/80-2007/08 was about 23%. For the period 1979/80-1991/92 the average annual growth rate was about 8% while for the period 1992/93-2007/08 the average growth rate was about 35%. The contribution rates of 10% remained unchanged for the last four decades or so. The rapid growth after 1992 and particularly the recent jump may be attributed to an increase in the size of the civil servants of the country. The federal arrangement has created regional government structures, which have more or less the same government structure as the federal government. Following this, district level decentralization has taken place in the country. These developments should have contributed to an increase of the size of the civil service and hence civil servants of the country.

Table 8: Average Growth Rates of Pensions for Different Periods

	1979/80-2007/08	1979/80-1991/92	1992/93-2007/08
Average growth rate of pensions	23.15	8.29	35.22

Source: MoFED

Figure 3: Pension Contributions (in Millions of Birr, 1974/75-2007/08)



Source: MoFED

Another reason for the jump of pension funds during the period 1998/99 and 2002/03 is an increment in salary of the civil servant. Moreover, the contribution of the government of 6% was not reported as pension funds in the past.

Another area of concern is the management of pension funds. Whatever pension fund is collected, it has to be properly managed so as to earn and contribute to the national pension fund. In Ethiopia, up to the recent five or so years, pension funds were being held idle in the hands of the government. At best the government was using it to supplement its recurrent expenditures.

Since the last five years or so, pension funds are being autonomously managed by a government agency, which can invest it in sectors it believed are safe and paying. So far the only feasible option available to invest the pension funds is government treasury bills, which however, are low-paying options. The government has been issuing treasury bills to supplement its recurrent budget deficit at very cheaper price. The fact that there are no

well developed bonds, stocks and secondary markets has constrained the utilization of pension funds.

2.6 Remittance

In this period of globalization, global flow of resources, including labor of different types has become a fact of life. This may indicate the fact that international migration will further increase into the future.

The literature recognizes both push and pull factors as the underlying causes for international migration. Different countries have different migration policies meant to attract different types of labor, skilled and unskilled labor. There are wider opportunities in different countries, mainly the developed countries that attract many from low income countries like Ethiopia. On the other hand, there are a multiple of push factors that cause international migration. Looking for better life, quite large Ethiopians have been migrating to different countries. Massive poverty, narrow employment opportunities, low payment, frequent famines, civil and inter border conflicts, political problems, search for better services (education, health) have been the major reasons for migration of many Ethiopians to the rest of the world. The relative importance of each causal factor may change over time. For instance, during the dictatorial military regime that ruled the country for the period 1974-1991, Ethiopian refugees were one of the largest numbers of African refugees in the world (Regt de Marina, 2007:6).

In this regard, different segments of the Ethiopian society have been targeting different destinations. The educated have been targeting to the North America, Europe and Australia. On the other hand, Ethiopian young females were trafficking to the Middle East, Saudi Arabia, Gulf States, Lebanon and Yemen, most often taking low pay domestic employments.

Though there is paucity of data, relatively speaking international migration is largely a recent experience for Ethiopians. Large Ethiopians were forced to leave the country since

the end o the 1970s owing to massive killings under the officially declared red terror, when large numbers of young scholars were murdered without due process of law.

Table 9: International Immigration

Country/region	Stock of Immigrants (000)			
	1960	1990	2005	2010
Ethiopia	393.3	1155.4	554	548
Africa	9,176	15,958	17,679	19,191
Low human development(HD) countries	4,266	8,928	8,468	8,812
World	77,115	155,518	195,245	213,944
Ethiopia share of Africa in %	4.29	7.24	3.13	2.86
Ethiopia's share of Low HD countries in %	9.22	12.94	6.54	6.22

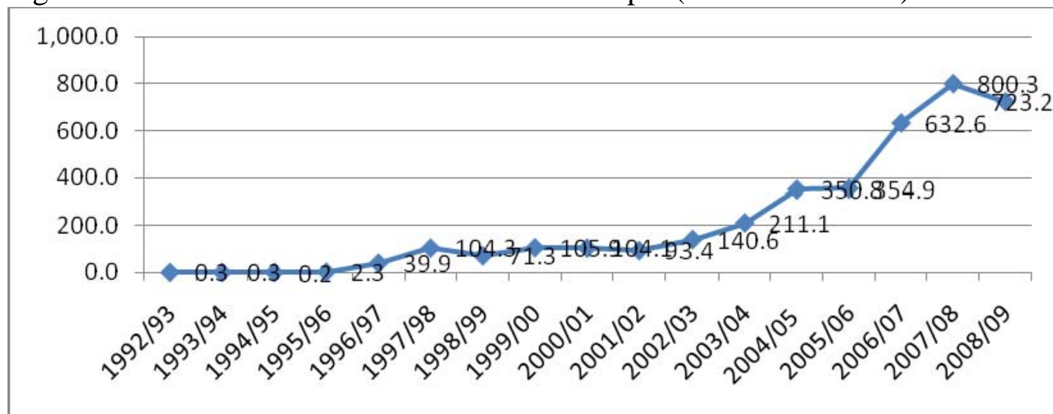
Source: HDR 2009:146

In the 1960s the size of Ethiopian immigrants were less than 400,000, which has increased to about 1.1 million in the 1990s, which should be attributed to the repressive political situation in the then Ethiopia. The migration of recent years is largely explained by economic factors. The figure reduced to nearly half a million in 2005 and remained stable at that level on 2010. The share of Ethiopian immigrants from the total African immigrants was about 4% in the 1960s, which increased to more than 7%. From then the share of Ethiopia has declined to less than 3% in 2010.

The Ethiopian Diaspora is largely a first generation one. This has implication on the flow of remittances. First generation migrant means there is fresh memory of home country. There is intimate relationship with family members, relatives, friends etc. This social attachment with the people at home and the childhood memory will remain natural inclination to support families and invest in birth-country Ethiopia. So utmost effort should be done to facilitate and effectively mobilize this source of finance as one source for financial resources.

As can be seen from the following figure, remittance has been growing from the order of US$ 0.3 million in 1992/93 to about US$ 800 million in 2007/08 which has declined to $723 million in 2008/09, probably due to the global economic crisis.

Figure 4: Amount of Remittance Inflow to Ethiopia (In Millions USD)



Source: NBE

If remittance is such an important source of resources to the Ethiopian economy, what should be done to enhance its inflow and utilization?

It is commendable that the Ethiopian investment code provides equal treatment of the Ethiopian Diaspora as resident citizens of the country. This is believed to stimulate the Diaspora to invest at their birth country.

Moreover, the central bank of the country (NBE) has permitted for remittance accounts in foreign currency in Ethiopia. This facilitates holding and saving remittance in foreign currency.

The fact that the financial sector is nascent may narrow down the scope for investing in different sectors of the economy. Strengthening the financial sector infrastructure may further encourage more remittance inflows and their efficient allocation. The infancy of the financial sector may remain a serious limitation in the near future in ensuring efficient allocation of remittances in Ethiopia. The financial sector should make continual endeavor to improve the relevance and quality of its services to attract more inflow of remittance to the country. Moreover, utmost effort should be exerted to encourage investment of the remitted funds.

The overall direction should be towards positively managing migration and ensuring quite responsive financial and investment system that adjusts with time to address timely problems of the Diaspora.

2.7 Capital flight: brief review of the literature

Another potential source of mobilizing domestic resource, which can enhance domestic saving is stemming and reversing capital flight. Economic development is nothing but a process of investing, generating surplus and reinvesting that surplus for further improvement, expansion or new investment. If for whatever reason the surplus, the value addition leaks out, then that leakage is a complete loss with severe repercussions on a given economy.

But what is the significance of capital flight as a problem of low income countries like Ethiopia? A recent study has come up with new evidence that shows the fact that Africa is a "net creditor" to the rest of the world. For the period 1970-2004, the study has estimated the size of capital flight for a sample of 40 SSA countries of which Ethiopia is one. The finding of the study shows the fact that "real capital flight amounted to $420 billion (in 2004 dollars). Including imputed interest, the stock of capital flight for this group of countries reached a staggering $607 billion dollars in 2004. This exceeds the countries' combined external debt by $398 billion, making Africa a "net creditor" to the rest of the world." (Ndikumana and Boyce, 2008:35)

Specifically, for Ethiopia, the study has estimated the fact that the real capital flight for Ethiopia was about 17 billion USA dollars, while the stock of capital flight as of 2004 was about 23 billion dollars. The net foreign assets, which is the difference between outflow and inflow for the year 2004 was about 16 billion dollars. Taking the capital/GDP ratio, it constitutes 175%. ((Ndikumana and Boyce, 2008:41)

Indeed, African leaders have recognized the very severity of the problem. The Joint Conference of African Ministers of Finance and Economic Development and Planning, in its twenty-fourth meeting on, 6 - 8 May 1999, convened in Addis Ababa, Ethiopia, has

acknowledged the fact that capital flight is one of the major development bottlenecks of Africa, the stemming and reversal of which could significantly contribute to domestic resource mobilization for ensuring sustainable socio-economic development of the continent.

One media of capital flight is trade faking which involves different forms of over- or under-invoicing of exports and/or imports of a country. The underlying causes could be overvalued exchange rate or high import duties or otherwise. In addition to addressing these underlying causes, governments should establish or strengthen required organizational capacity to minimize capital flight.

One manifestation of capital flight is corruption, which has got an official recognition in the country. Yet beyond establishing anti-corruption organization, it requires more commitment in addressing the underlying factors for corruption, which are related with weak institutional capacity to ensure accountability of every citizen including officials.

Policy implications of the review on capital flight suggest that one of the preconditions for controlling or minimizing the capital flight is establishing stable macroeconomic environment. This may involve avoiding an overvalued exchange rate, and free access to foreign exchange. This is easier said done, for countries like Ethiopia, which have severe foreign exchange constraint that is making rationing compulsory. The strategic direction is to boost the export sector, which needs to be complemented through timely market driven devaluation.

One of the factors believed to contribute to capital flight is the weak financial sector. Repressive financial system is believed to contribute to capital flight. The development of financial sector, facilitation of investment in the country will contribute to minimize capital flight.

Yet, establishing or strengthening the required institutions of surveillance, monitoring and system of accountability comes as priority intervention area to manage and minimize capital flight.

2. Depth and Structure of the Ethiopian Financial Sector and its implication to Domestic Financial Resource Mobilization

3.1 Introduction

Sustainable socio-economic development requires the development of an efficient and well developed financial sector[11]. A full-fledged financial sector is one of the core market institutions that ensure the supply of long term capital to the economy. One of the fundamental functions of the financial sector is to mobilize saving and channel it to investment. In fact a well matured financial sector is one that provides a variety of financial instruments. On the one hand, it offers different rates of return, risk, and maturities to savers and on the other it provides alternative sources of finance at varying interest rates and maturities to investors. Financial sector development is, therefore, the development of different financial institutions including commercial banks, development banks, saving and loan associations, credit unions, insurance companies, mutual funds,

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[11] For some time, there has been an outstanding debate on the causal relationship between financial development and economic growth. There are quite number of studies with different conclusions and concerns over the direction of causality between economic growth and financial development. The performance of countries and hence their research results, could be different due to different reasons. For some countries investment could be financed from cash inflows, FDI, grants, foreign loans etc. In such a situation, domestic credit channeled to the private sector could be small to come up distinctly as a strong variable to explain growth. The purpose of the present study does not intend to contribute to resolve this debate on causal relationship between saving and growth. In view of persistent high saving-investment gap, the inadequacy of external resources and inherent less desired conditionalities of external resources, low income countries like Ethiopia should give due attention to develop the institutions for domestic resource mobilization, including developing the financial sector.

pension funds which intermediate between lenders(savers) and borrowers (investors) with well nurtured financial markets including loans, bonds, equity, asset-backed primary markets and secondary derivative markets(Chami, et al, 2009:4).

In this section, the intent is to assess the development of the financial sector in view of its capacity to mobilize private saving and channel it to investment. The other component of domestic saving is private saving, which is channelled through the financial sector. So this section assesses the nascent Ethiopian financial sector in terms of the range, depth and outreach of services being provided to the national economy.

3.2 Outreach of the Ethiopian financial sector and its structure

This subsection reviews the development of the financial sector, covering the banking, non-banking and related others. At present, the major financial institutions operating in Ethiopia are banks, insurance companies and microfinance institutions. Each of these financial institutions will be briefly assessed in subsequent pages of the present paper.

3.2.1 The Banking sector

Despite a long history of money use in Ethiopia, and history of a century of modern banking, the financial sector in general and the banking industry in particular remain nascent. While, the history of modern money dates back to more than 2000 years, the first modern bank was established in 1905. Apart from the banks that were short lived during the Italian five year invasion, a number of banks and the Central Bank of the country were established during the 1960s[12] (Gedey, 1990). Before the 1974 military takeover of power, there were domestic, fully foreign and jointly owned banks in the country.

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[12] For instance, the National Bank of Ethiopia (central bank of the country) and the largest commercial bank in Ethiopia, the Commercial Bank of Ethiopia(CBE) were established in 1963. Moreover, the Development Bank of Ethiopia was established in 1969.

In 1975, all financial institutions, the banks and insurance companies, were nationalized, following the socialist ideology of the then military government. In addition, the major means of production of the country, land, all manufacturing enterprises were nationalized. In fact, the role and significance of the private sector, the type and extent of private involvement, were delimited. It put a ceiling of Birr 200,000 ($96,000)[13] for retail establishments, Birr 300,000 for wholesale establishments and Birr 500,000 (raised to one million in 1985) for industry. During this period of military rule (1975-1991), all formal financial institutions were state owned, and the investment and hence new entry and operations were state-controlled. Moreover financial prices were controlled by the state (Ageba, 1997:55).

After 1992, financial reforms were undertaken in Ethiopia, which include elimination of credit discrimination, interest rate liberalization, reduction of government control and introduction of market-based business operation management (Ageba, 1997:64).

Currently, the Ethiopian banking sector involves, the central bank, both state and privately owned commercial banks, one development bank (of course state owned) and another mortgage bank, entirely locally owned companies. So far there are no foreign owned banks in the country.

One of the outcomes of the financial reform is its opening up to the private sector. Following, the Monetary and Banking Proclamation No. 83/1994 and the Licensing and Supervision of Banking Business No. 84/1994, a number of commercial banks and insurance companies were established since 1994. In fact, nearly after four decades or so, the first private commercial bank was established in 1995. Since then ten private commercial banks are established. As of 2009, there are three state-owned and ten private banks in the country, all of which are locally owned. There are few more under establishment.

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[13] The then exchange rate was Birr 2.07 to one USA dollar.

One of the state owned banks is the Development Bank of Ethiopia with the primary objective of financing investment in different sectors of the economy. The mission of this bank is to excel in project financing, which involves mobilization of resources from different sources and channel them to medium and long-term investment credits. The major sources of funds are deposits (Time and Demand) contributing to about 25%, inter-bank loans holding another 25% and equity is represented by 50%. In addition the bank looks for donor support to promote its ideals.

In total, all the 13 banks have got 596 branches in different parts of the country. Out of these branches, 232 of them, constituting about 39% are located in the capital city of the country, which is also the largest economic and business center in the country. The rest 364 branches (constituting about 61%) are established in different parts of the country, concentrating in major urban centers. For a population of nearly 75 million, we have less than 600 branches, which is about 1 branch for about 125,000 persons. These branches are concentrated in major urban centers, regional cities and some relatively bigger towns. Taking the urban population of about 12 million (as of 2007), one branch serves about 20,000 persons in urban centers. So far there has not been any branch operating in the rural side of the country. This shows the fact that Ethiopia indeed, is under-banked country with limited outreach.

Table 10: Number of Bank Branches and Capital as of the 2nd quarter of 2008/09

Banks/Insurance	Number of banks/ insurance	No. of Branches (in number)				Capital	
		Regional urban centers	Addis Ababa (AA)	Total number of branches	% share from total	(in Million Birr)	Share of capital from total
State owned commercial & development and mortgage bank	3	206	62	268	44.97	6,699	63.8
Private commercial banks	10	158	170	328	55.03	3,803	36.2
Grand banking sector	13	364	232	596	100	10,502	100
Public insurance	1	27	11	38	21.5	238.8	39.1
Private insurance	10	59	80	139	78.5	371.5	60.9
Total insurance	11	86	91	177	100	610.3	100

Source: Source: NBE, Quarterly Report, 2008/09, Vol 24, Quarter 2,

One may observe that the Ethiopian banking industry is underfinanced itself with a total capital of Birr 10.5 billion, which is about US $840 million [14]. This constrains the size of credit available to the Ethiopian economy. It can only finance very few large investment worth of hundreds of millions. The banking sector cannot be expected to finance major physical infrastructural works, like hydro electric power stations and other infrastructural works that require multi-million investment costs. In fact the researcher is aware of the fact that before ten years or so, one of the challenges of an already established cement project was the fact that there was no bank that could finance the project. So the few banks, specifically the largest state owned commercial bank and the development bank had to create a consortium to finance a cement project worth of about US$ one billion.

Moreover, it is highly concentrated in one state owned commercial bank, which owns 43.4% of the total capital. In general the three government banks hold about 64% of the total capital. The size of capital of the remaining ten private commercial banks is about Birr 3.8 billion ($303 million), with an average of Birr 380 million ($30million). As of this year, the size of capital of the private banks ranges from Birr 95 million to 676 million ($8 million to $54 million). The share of the largest bank (in terms of capital ownership) is only 6.4% of the total. This implies that none of the private banks have the capacity to finance large investment worth of a billion dollars.

In terms of number of branches, similar market structure is observed. Out of the total bank branches of 596, the state owned and largest commercial bank owns 209 branches across the country, which is about 35% of the total. The state owned banks as a group own about 45% of the branches. The private sector owns the remaining 55% of the branches in the country. The highest share of branches from the privately owned banks is only about 10% with 58 branches, followed by the next largest number of branches of 51 branches. A newly established bank has started with only branch in the capital city recently during 2008/09.

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[14] The official exchange rate at the time of writing this paper was Birr 12.55 per one US$.

So far there has not been any capital market[15] in the country. Thus, essentially, it is the task into the future. The maturity of the financial sector can be measured by the state of development of the capital market. Capital market has a critical role in mobilizing and channeling long-term capital to the economy.

The only experience which might be considered as an element in the capital market is the treasury bills auction by the government. This is essentially a money market meant to mobilize money for the government, which is a short-term investment. The Government issues treasury bills for its money market operations. "A Treasury bills market, in which bills are auctioned fortnightly, is the only regular market where securities are transacted. Government bonds are occasionally issued to finance government expenditures and/or to absorb excess liquidity in the banking system". (NBE, Annual Report, 2006/07: 44) There is no secondary market for these treasury bills, limiting their impact.

Table 11: Results of Treasury Bills Auction

Particulars	2007/08	2008/09	
	Qtr II	Qtr I	Qtr II
Number of bidders	52	71	74
Public	38	49	54
Private	14	22	20
Number of bids accepted	60	81	84
Public	38	55	60
Private	22	26	24
Amount Supplied (Mn.Birr)	18,087.00	7,622.00	7,657.00
28-day bill	6,500.00	1,305.00	960.00
91-day bill	6,774.00	3,885.00	4,031.00
182-day bill	4,813.00	2,432.00	2,666.00

Source: NBE, quarterly report, 2008/09

[15]The capital market is the market for securities, where governments and companies can raise long-term funds for investment by issuing different types of securities. Thus it is the market for mobilization of savings and channeling same into long-term productive investments. It is a complex market involving different markets, stock, bond and other markets involving both primary and secondary markets. In these diverse markets, different agents and operators operate and they require different resources and institutional capacity. Establishment of an effective and efficient capital market requires holistic approach involving the development of many institutions, supporting infrastructure and strong regulatory system. For detailed discussion one may consider Chami, et al, 2009, Torre & Schmukler, 2007.

As can be observed from the table above, it has been a primary market involving only small players, not exceeding 75 in the second quarter of 2008/09. Since there are no secondary markets, the impact of treasury bills was limited to the size and structure of the treasury bills. The treasury bills involve short term transactions involving 28-day, 91-day and 182-day bills.

Another indicator of the low level of development of the Ethiopian banking industry and which may be promoted to contribute to the development of a capital market is inter-bank money market, which has remained at quite low level. The number of inter-bank transactions has been very few in number involving only small size of money. For instance, during 2006/07 only five inter-bank transactions were effected in the entire year.

In a decade period of time, up to June 2007, and since the introduction of the inter-bank money market in September 1998, merely seventeen transactions worth of Birr 259 million were transacted with interest rates ranging between 7 and 8 percent. This means less than two transactions per year, involving about Birr 25 million per year only. Subsequently, “during the year 2007/08, only four inter-bank money market transactions were undertaken involving Birr less than Birr 200,000**.** No inter-bank money market transaction was conducted in the first and second quarters of 2008/09. The maturity period of these loans widely spanned from overnight to 5 years. Persistent excess reserves in the banking system and lack of collateral in the case of private banks have mainly contributed to the poor performance of the inter-bank money market in Ethiopia” (NBE, Annual Report, 2006/07: 46).

In addition, recently few individual initiatives to promote certain industries by selling shares are evolving in the country. A number of promoters are indeed selling shares to invest on different industries. Such attempts include cement, sugar, agriculture based, real estate and others.

3.2.2 Non-bank financial institutions: insurance and micro-financing institutions

Often significant saving and financing through non-bank forms are indicators of financial diversity because bank deposits and loans constitute the traditional forms of savings and credit in many countries.

NBFIs directly or indirectly enhance the mobilization of savings. They directly provide alternative saving and investment options. Moreover, the synergy effect of all banking and NBFIs is believed to be larger than the isolated development of each financial market.

The NBFIs include different financial institutions including insurance and finance companies, investment banks, pension and mutual funds.

In Ethiopia, the non-bank financial institutions include insurance companies and micro-financing institutions. The lack of diversification of the NBFIs is another indicator of the infancy of the financial sector of the country.

Similar to the banking sector, the insurance industry too is nascent with only 11 locally owned companies having 177 branches across the country, with a total capital of Birr 610.3 million. Private insurance companies accounted for the lion's share (78.5 percent) of the total branches. Of the total branches of insurance companies, 51.4 percent were situated in Addis Ababa. During the central command economic management system, there was only one state-owned insurance company. After the financial reform of the early 1990s, ten privately owned insurance companies have emerged in the Ethiopian financial market. In terms of outreach, one branch insurance company in the country serves almost 441,807 people, showing the extent of infancy of the industry in Ethiopia. (NBE, Quarterly Report, Vol 24, Quarter 2: 28).

The other non-banking financial institution is micro-finance institutions (MFIs), which has reached 28 in number. As of the second quarter of 2008/09 (December 2008), all the MFIs have mobilized Birr 1.8 billion in savings and their credit outstanding reached Birr 4.8 billion. The top five large MFIs, which are directly or indirectly affiliated to the

government, accounted for 84.7 percent of the total capital, 93.0 percent of the savings, 90.7 percent of credit, and 90.9 percent of the total assets of the MFIs operating in the country" (NBE, Quarterly Report, Vol 24, Quarter 2: 28).

As of December 2008, the total number of active clients of the MFIs was only 2,220,901 (in number). The total asset of the industry was Birr 5.5 billion, which is composed of 4.06 billion liability and Birr 1.401 billion capital (retrieved from http://www.aemfi-ethiopia.org/ as of August 4, 2009) .

The size of outreach has been increasing rapidly from year to year. For instance in the years 2003, 2004, 2005, 2006 and 2007, the number of active clients were, 755,073, 1001,073, 1,277,939, 1,518,245 and 1,711,539 members, respectively (NBE).

The critical problem of the sector is sustainability, which is related with the high risk of default and the high transaction cost to enforce contracts. Understandably, the collateral of the Ethiopian poor is very low. In some regions, which are affiliated with the government, they use government machinery to enforce collection. Otherwise, the default rate of MFI which are not affiliated to the government is high, which may compromise the very sustainability of the industry. There are even legal problems, related to the right of closure/disclosure/. MFIs cannot declare disclosure like the commercial banks. So MFIs are operating in a different policy framework, different from the policy on the banking and financial sector in general.

In general, the financial sector is at its infancy, with low institutional capacity. For instance one of the bottlenecks of the Ethiopian financial market is lack of credit information registry system, where banks could consult in deciding to whom to lend.

3.2.3 Ethiopian informal financial sector

Markets have evolved from personal exchanges to impersonal exchanges. It appears that the Ethiopian financial sector has not finished its evolution from personal to impersonal exchanges. There are large segment of the economy which relies on informal financial

institutions. These financial markets address the demand and needs of a specific community, specializing in small but with short-term transactions (Nissanke, and Ernest, 2006:7).

For Ethiopia, there has not been formal research that could help to determine the relative significance of the informal financial sector. Yet, there are studies and observations that indicate the fact that the informal sector may exceed the formal sector in terms of coverage, influence and even the total value of transactions (Nissanke, and Ernest, 2006:7).

In this regard, UNCTAD states the fact that,

> *"Officially recorded rates of savings do not measure the full extent of potential resources that could be mobilized in African countries. Indeed, savings in the formal financial sector represent only a small fraction of the total. Most savings are held either in non-financial assets or in the informal financial sector. Indeed, studies suggest that non-financial assets represent around 80% of all household assets in rural areas. These modes of saving outside the formal financial system are much less amenable to accurate capture by national statistics."* (UNCTAD, 2008: 7)

The demand for credit is complex involving different economic agents. These heterogeneous economic agents have different capacity and access to different types of credit. There is a sector, which relies on the formal sector. This is a sector that can afford and present acceptable collateral to the formal financial sector.

On the other hand, there is good size of the financial market that is being served by the informal financial sector, which covers the financing need that is not met by the modern banking industry and micro financing industry.

Typical income group that has remained marginalized from the formal financial sector is the poor, both rural and urban poor. Let alone for the rural poor, the rural rich does not

have physical access to formal banks and non-banking institutions. In Ethiopia, the formal financial sector has been confined to major urban centers. To address the financing needs of these inaccessible groups, MFIs have emerged since the early 1990s, but definitely remotely distant to satisfy the needs of the Ethiopian rural poor.

Not only is the outreach of MFIs limited in terms of covering the entire country, even in areas where MFIs operate, there are a number of factors that constrain access to MFIs.

Quite large number of the Ethiopian population, who do not have access to formal institutions, save their money in terms of precious metals, like gold and silver. They buy golden ornaments, partly believing that they can sale the same, at a latter period of their life. There has not been a research to quantify the magnitude of such saving. But the present researcher is of the opinion, that this type of saving involves quite significant magnitude of saving. If the society has an access to secured and attractive alternative, and upon a good deal of marketing effort, large saving could have been mobilized. In addition, a large part of the pastoralists, hold their wealth in terms of having large stock of livestock. If there were good access to market and an option to saving and invest in alternative investment areas, large resource could have been mobilized. Thus there is a good deal of opportunity to mobilize large resource, which has been saved in kind due to lack of diversification of and access to formal financial institutions.

Moreover, parallel to the formal finance institutions, a number of informal institutions operate in the Ethiopian financial market.

One such informal, in fact illegal financial market is the private moneylenders, which lends to both low-income group and middle income earners, at exorbitantly high interest rate. For instance in cash cropping localities, large private commercial farmers face severe shortage of working capital during the harvest period.

Under the existing banking arrangement, neither land nor the agricultural produce on the farm can serve as collateral in the formal banks. So at times of need, usually during the harvest period, farmers are obliged to borrow at 10-15% per month from money lenders.

In general, though there has not been a formal research to determine the size of this market, different business people recognize that there is huge market. The challenge is to come up with institutional innovativeness to formalize this market, which could boost the saving and intermediary functions of the financial sector.

The other informal but quasi legal financial institutions are social forums of saving and collective insurance. Since Ethiopia is a very heterogeneous society, involving different religions and ethnic groups with different cultural set up, it is difficult to come up with exhaustive list of the informal financial institutions.

Yet, there are some informal institutions that are commonly known and operate side by side the formal financial market. Such informal institutions include Iqquab and Iddir. These are group-based informal financial institutions which provide financial services including saving and collective insurance. Iqquab is basically a saving institution, where members would contribute some agreed amount per agreed day/week/month. The saving rate and the time interval of saving are initially negotiated. Once these are agreed upon, they will remain in force up until the saving cycle is completed. Every member contributes the agreed amount, every period. In each collection, a member draws a lottery to take the mobilized money. This way, Iqquab has been serving as an informal saving institution in large parts of the country. This Iqquab, though informal, it has been commonly recognized social forum, which is legal to be a member of such institution.

The other is a sort of collective insurance, Iddir, where group of people negotiate and establish such forum in order to support each other at times of need. Members contribute and regularly pay some fee/contribution/ and they will be entitled to certain financial and social support at bad times. Essentially, these are mutual assistance associations.
The major service provided by the informal finance is saving and provision of credit to members, both in cash and kind. Because of their informality, the transaction costs of such financial services are low, since there is no overhead cost, at all. The social relationship of members and the society at large is the effective binding enforcing mechanism.

The challenge is to come up with institutional innovation that could graduate the informal institutions to formal one and hence develop a mechanism whereby the formal financial institutions could develop instruments that can effectively serve these informal but effective institutions that are believed to mobilize significant volume of saving in the country. The coexistence of the formal and informal financial institutions has strong policy implications. If they coexist, would there be mechanism that enables them to work together, is a researchable issue.

3.3 Financial deepening and intermediation measures

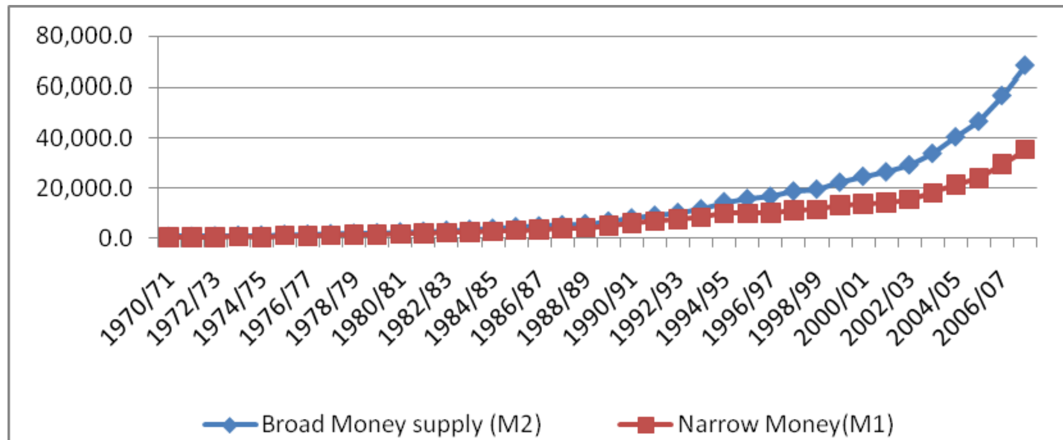
This subsection discusses the degree of deepening of the Ethiopian financial sector. It reviews the degree of monetization (taking the ratio of broad money to GDP), the performance of deposit mobilization and the allocation of credit to the private sector.

3.3.1 The degree of monetization of the Ethiopian economy

One of the indicators of financial development of an economy is the ratio of broad money (M_2) to GDP. Provided the subsistence agriculture dominated economy, low urbanization rate, low income and high absolute poverty, the level of monetization of the economy is expected to be low. The ratio of broad money (M2) to GDP is expected to be low. As the level of monetization of the economy increases the share of broad money is expected to rise.

As can be seen from the following figure, a data set since 1970/71, shows the fact that both M1 and M2 were sluggish during the pre-reform (1992/93) and have been increasing fast during the post reform period. The data set shows the fact that broad money has been increasing, after 1992, indicating the fact that the monetization of the Ethiopian economy has been increasing in the last two decades or so.

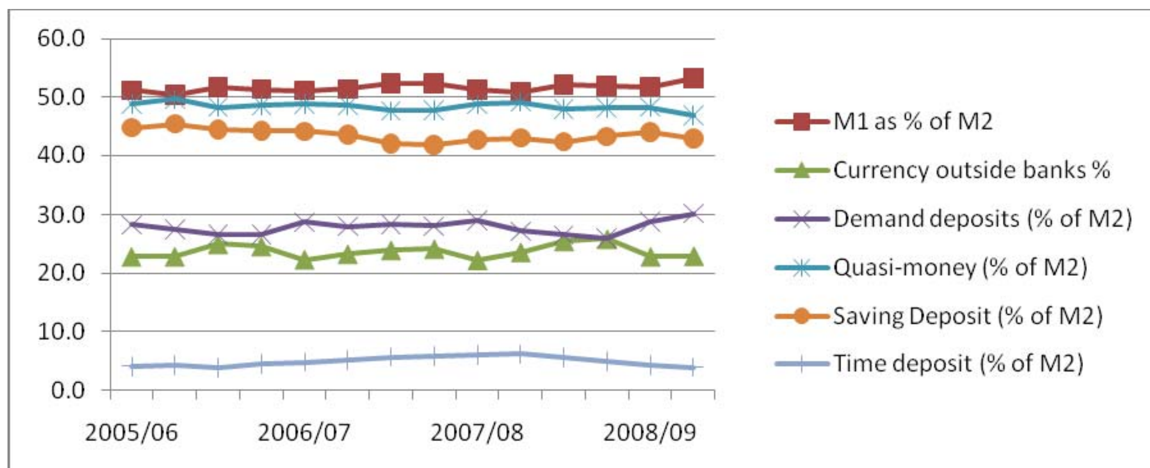
Figure 5: Growth trend of narrow and broad money, for the period 1970/71 to 2006/07



Source: MoFED and NBE,

Obviously, the relative contribution of each element of broad money matters in taking broad money as an indicator of financial development. The post reform growth of broad money is explained more by deposits. The share of quasi money and specifically saving deposits constitutes the highest percentage of broad money (M_2) in the given period of time. The second largest contributor is demand deposit.

Figure 6: Percentage Share of Broad Money (M_2) Elements (Quarterly 2005/06-2nd quarter of 2008/09)



Source: NBE

So currency outside the banks constitutes the smaller percentage compared with both demand deposits and saving deposits. The average percentage share of narrow money

(M_1) out of the broad money supply for the period 2005/06-second quarter of 2008/09 was about 52%. The share of quasi-money for the same period was 48%. Therefore, the largest contributor to total money supply has been saving deposits with an average percentage share of about 44%, followed by the second largest contributor of demand deposits that accounted for about 28%. So the growth rate of M_2 can be attributed to saving and demand deposits which together constitute for about 72% in the given period.

For the recent decade, however, a related but different data set on SSA shows the fact that the percentage share of broad money to GDP has been consistently declining from the order of 36% in the period 1997-2002 to 23% in 2009 and is predicted to slightly reduce to 22% in 2010.

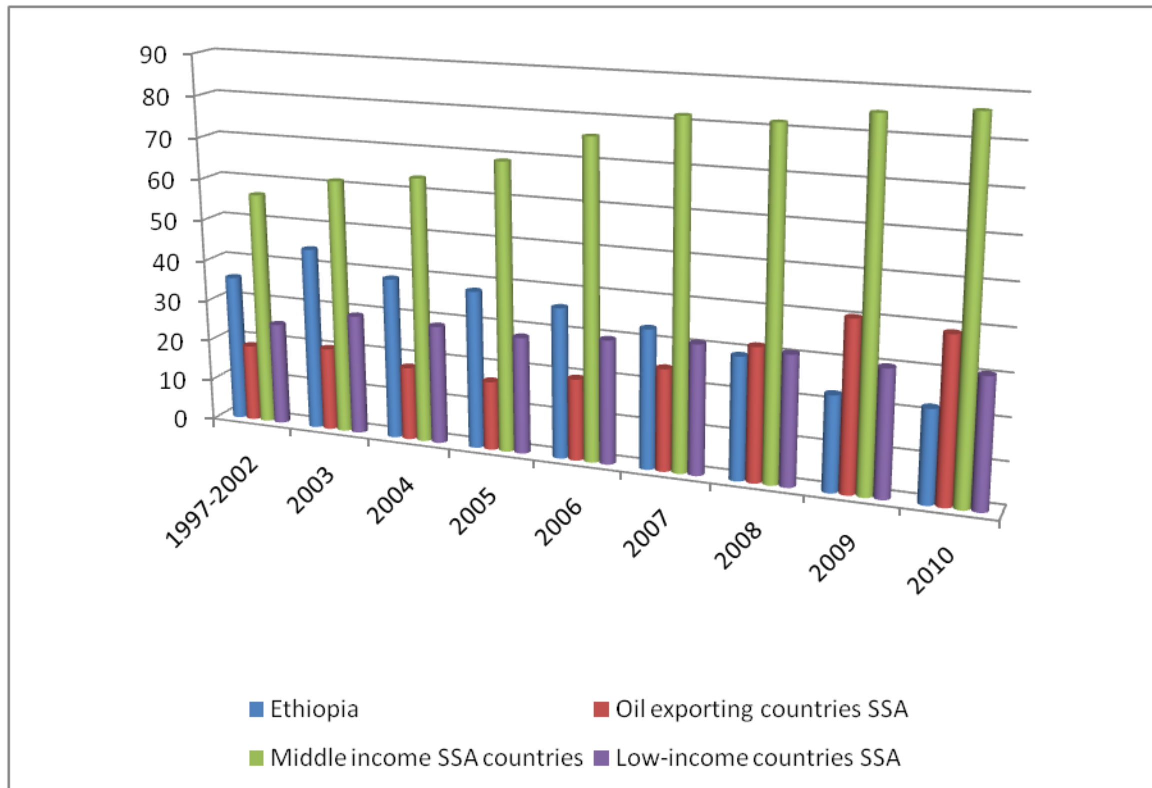
Table 12: Broad money (percent of GDP)

Country, regional averages	1997-2002	2003	2004	2005	2006	2007	2008	2009	2010
Ethiopia	**35.5**	**44.3**	**39.0**	**38.0**	**36.1**	**33.3**	**29.2**	**22.7**	**22.1**
Oil exporting countries SSA	18.6	20.1	17.7	16.6	19.6	24.4	31.8	40.4	39.1
Middle income SSA countries	**56.5**	**61.4**	**63.6**	**69.0**	**76.0**	**81.9**	**81.7**	**85.0**	**86.6**
Low-income countries SSA	24.8	29.0	28.6	28.1	29.7	31.0	30.9	30.1	30.7

Source: International Monetary Fund (IMF), 2009: 74

Since 1997-2002, while the share of broad money to GDP has been increasing for all SSA groups, oil exporting, middle income and low income SSA countries, it has been it has been falling for Ethiopia. For the low income SSA countries, the ratio has increased from the order of 25% to about 30% in the same period.

Figure 7: Broad money (percent of GDP) Percentage share of Ethiopia's Broad money of GDP and SSA averages, 1997-2002 to 2010



Source: International Monetary Fund (IMF), 2009: 74

For the middle income countries, the increase of the ratio appears to be dramatic. It has increased from a high rate of about 56% in 1997-2002 to about 87% in 2010. Compared all SSA income groups, the percentage share of broad money to GDP has been low in the given period.

3.3.2 Deposit mobilization: saving, time and demand deposits

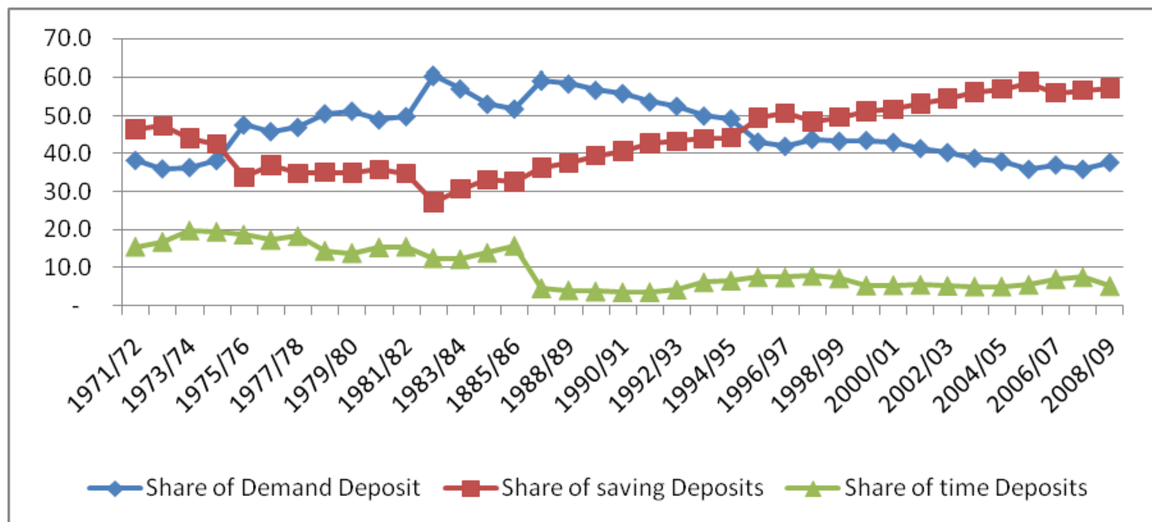
One of the major functions of the financial sector is to intermediate between lenders and borrowers. Apart from providing other services, financial institutions mobilize funds using different saving instruments and then lend it to different segments of the economy. Therefore, one performance indicator of the financial sector is the extent of saving deposits over time.

The other function of the financial sector is to serve as payment media, where different economic agents use the bank to conduct their payments. With development, the bank

remains the safest and largest mechanisms of payment. Thus, the performance of demand deposits can be taken as an indicator of the development of such service of the bank.

During the entire period of 1971/72-2008/09, saving constituted on average 44% of the total deposits while the average share of demand deposits was about 46 %. The share of time deposits has been consistently low, with an average of 9.8% in the given period. However, there has been inter-policy regime difference in the relative share of each deposit type. During the 1974/75-1991/92 period while the share of demand deposits was 53%, the share of saving deposits (SD) was 35%, probably indicating that saving was highly suppressed during the command economy. In the subsequent policy regime, since 1992/93, the relative position of saving and demand deposits(DD) have shifted in favor of saving deposits(SD). While the share of DD has declined to 42 %, the share of SD has increased to 52%. In fact, since 1994/95, saving deposits has been greater than demand deposits. In fact, the gap between saving and demand deposits has been increasing during the period since 1994/95. This can be vividly seen in the figure just below, where the curve for saving deposits was increasing, while that of the demand deposits is showing a declining trend. The share of time deposit remained consistently low at less than 10%.

Figure 8: Percentage share of different types of Deposits over 1971/72-2008/09



Source: NBE

If one considers the periodic growth rates of total deposits, one can see that the growth rate of total deposits has been about 16% with small inter-regime difference. The average growth rate of saving deposits over the period 1971/72-2008/09 was about 17%. For the period 1974/75-1991/92, the average growth rate of saving deposits was about 17%. For the subsequent period, since 1992/93, the average growth rate was about 19%, for the recent years the average growth rate exceeded 20%, in fact reaching about 25% for the year 2008/09. During the recent three to four years, there has been double digit inflation in the country, bringing down the real interest to negative values. Yet, despite this inflationary situation, saving has been increasing. The main reason for such an increase of saving during inflationary situation is the fact that there has not been any alternative investment/saving/ that savers could consider as an option which can be taken as an indicator of the embryonic stage of the financial sector despite the rate of growth of total deposits and its elements.

The average growth rates of demand deposits for the entire period 1971/72-2008/09, 1971/72-1974/75, 1975/76/1991/92, and 1992/93-2008/09 were about 17%, 9%, 21% and 14%. For the years since 2001/02, the annual growth of demand deposits was less than 10% but picking up for the recent years.

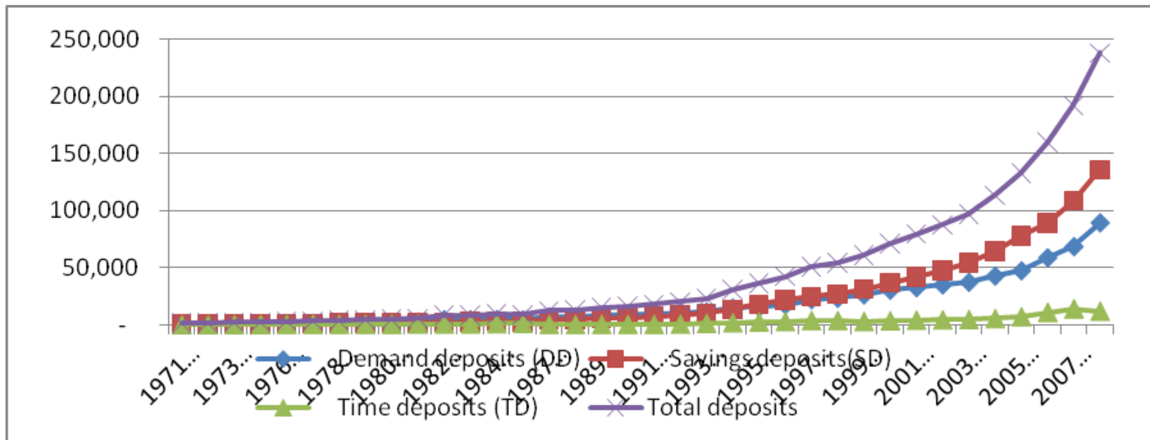
Table.13: Percentage Distribution of Deposits & their annual growth rates (1971/72-2008/09)

Deposit Item	1971/72-2008/09	1971/72-1974/75	1975/76/1991/92	1992/93-2008/09	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09
Share of DD of TD	46.3	37.2	53.0	42.0	41.4	40.3	38.8	37.9	35.9	37.0	35.9	37.7
Share of SD of TD	44.0	45.0	35.4	51.9	53.2	54.5	56.2	57.0	58.7	56.0	56.7	57.1
Share of Time D of TD	9.8	17.8	11.7	6.1	5.5	5.2	5.0	5.0	5.5	7.0	7.4	5.2
Growth rate of TD	16.0	17.8	16.7	16.5	11.2	10.3	10.7	17.0	17.2	20.0	20.1	24.0
Growth rate of DD	16.6	8.7	20.6	14.3	7.1	7.5	6.4	14.4	10.8	23.9	16.5	30.2
Growth rate of SD	16.8	6.3	16.8	18.6	14.5	13.0	14.1	18.7	20.6	14.5	21.6	25.1
Growth rate of Time D	14.8	20.3	7.4	20.9	13.4	4.8	7.8	16.9	27.2	54.0	27.5	-14.0

Source: NBE, TD= Time deposits, DD= demand deposits, SD= saving deposits.

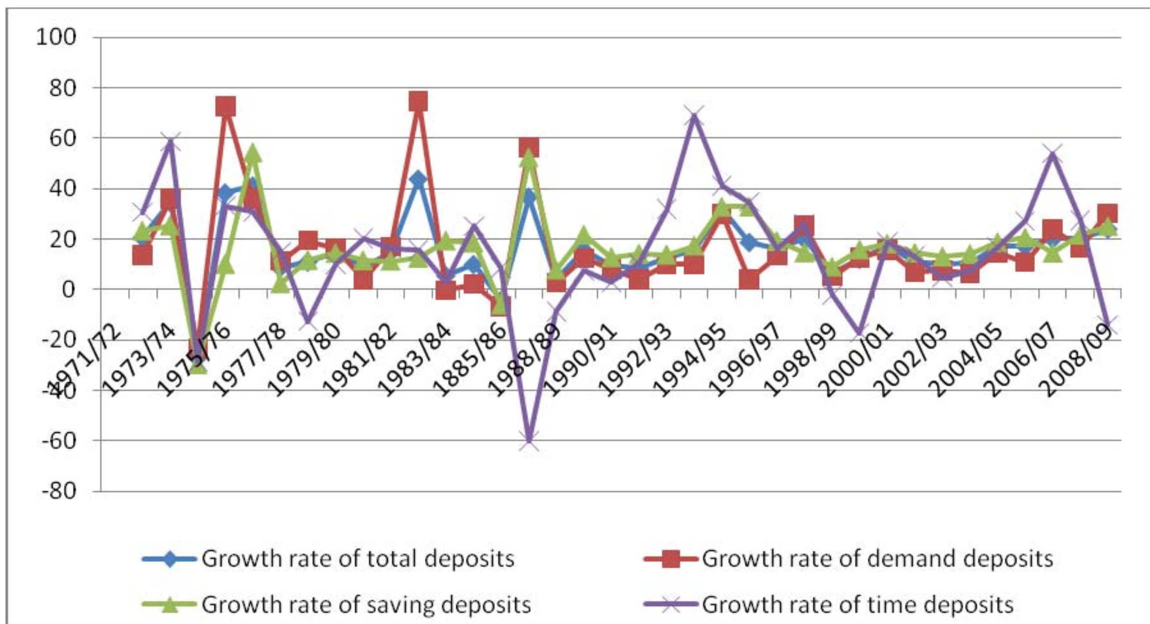
Figure 9: Trends of Different Types of Deposits, Demand, Saving and Time Deposits 1971/72-

2008/09



Source: NBE

Figure 10: Annual Growth Rates of Different Types of Deposits, 1971/72-2008/09



So note that except for one year downfall of time deposits, saving and time deposits have been increasing even during inflationary periods, 2007-09.[16]

[16] Ethiopia has experienced inflationary situation since 2005/06. During the 2006, the monthly average growth rate of the general price index was in the range of 10-13%. During 2007, the range picked up from

In general, apart from the negative real interest for saving deposits, there has not been any discrimination against any individual who intends to save whatever amount. It is very accessible and easier to save and withdraw.

On the other hand, reflecting on the experience of the East Asian successful countries, one does not observe any change in the deposit structure in Ethiopia. Throughout banks has never been pursuing aggressive and innovative saving instruments. In the entire period, the same saving and payment instruments have been used in the banking sector, without any change.

3.3.3 Credit flow to the private sector

One of the basic functions of the financial sector is to provide intermediary services, channelling saving to investors. Ultimately credit channelled to the private sector, represents the actual service of financial sector to the economy in general and the private sector in particular. It represents the function of the financial sector to mobilise resources (saving) and channel it to investment that brings about economic growth. "The supply of credit to the private sector is ultimately responsible for the quantity and quality of investment and, in turn, for economic growth, this variable may be expected to exert a causal influence on real GDP per capita" (Demetriades and Hussein, 1996:395).

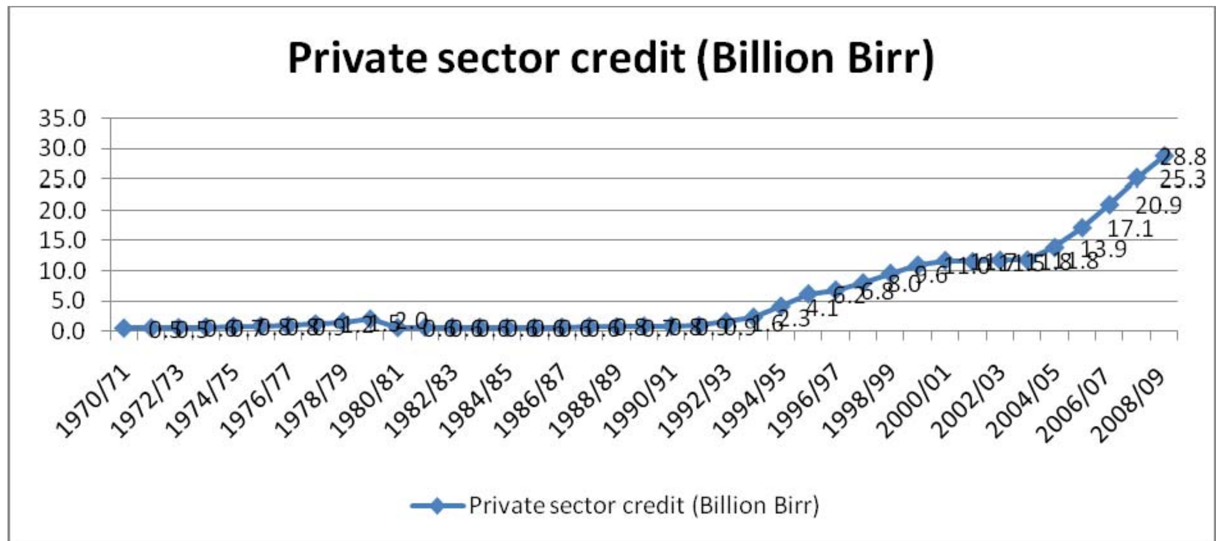
One possible indicator of the extent of financial deepening could be the size and trend of credit flow to the private sector. The larger and growing trend of disbursed loans, the larger the financial sector. So the trend of credit may be considered as a complementary indicator of the development of the financial sector.

13% to 18%. In 2008 the index was in the range of 18% to 44%, which further increased to reach 46% in January 2009. Same trend was experienced during the first six months of 2009.

Private credit grew from the order of Birr 500 million in 1970/71 to nearly Birr 30 billion in 2008/09. In this entire period of nearly four decades, the average growth rate of private credit was about 14%. During same period, the average ratio of private credit to GDP was 9.8%.

Yet, there have been significant inter period differences in the magnitude and share of private credit in Ethiopia. As can be seen from the following figure, private sector credit remained low for the period 1970/71-1991/92 and then it has dramatically picked up in the subsequent period of 1992/93-2008/09. The two clear periodic differences show the credit history of the country involving three policy regimes.

Figure 11: Private Sector Credit for the period 1970/71-2008/09



Source: MoFED and NBE

The first five years, 1970/71 -1974/75, represent the state of credit allocation to the private sector, under apparently free market system, but essentially feudal regime, dominantly agricultural economy, with less development endeavors. Yet, compared with the subsequent period, the average share of private credit from GDP was 8.6% with average of annual growth rate of about 11.8%.

The subsequent period of 1975/76-1991/92 is a period of a policy regime that has discriminated the private sector at a policy level. Credit priority was setup in favor of publicly owned enterprises and cooperatives but against the private sector. Indeed, the average share of private credit from the GDP of the same period was the lowest average of the entire period, which is about 6.9%. The average growth rate of private credit of the same period was still the lowest, 4.8%, compared to the previous and subsequent periods of different policy regimes.

Table 14: Average percentage share of private credit from GDP and its Growth rate

Period	Average Share of Private Credit from GDP	Average Annual Growth Rate of Private Credit
1970/71-2008/09	9.82	14.38
1970/71-1991/92	7.24	6.11
1970/71-1974/75	8.55	11.83
1975/76-1991/92	6.86	4.77
1992/93-2008/09	13.16	24.58

Source: MoFED.

The magnitude of private credit has shot up following the change in policy regime from central command to free market system, and specifically after the financial reform following the 1991 takeover of political power of the existing EPRDF regime. Following financial reform, which abolished credit discrimination against the private sector, private credit has been growing on average at nearly 25% for the period 1992/93-2008/09. During the same period, the average share of private credit to GDP has increased to about 13%. The expansion of private credit since 1992/93 can be attributed to changes in the policy regime, which avoided discrimination against the private sector and in fact has been encouraging the private sector using different policy instruments, like favorable lending interest rate (NBE, Annual Report, 2006/07:2).

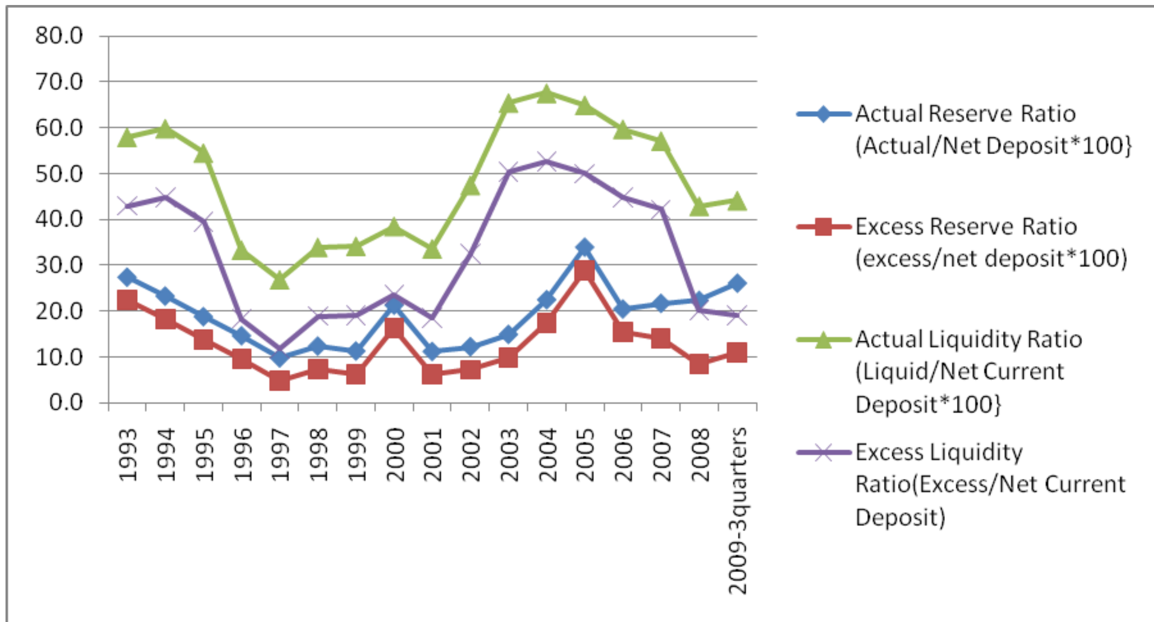
3.4 Excess reserve and liquidity position of Ethiopian commercial banks

Obviously, the central bank of a country should ensure the healthy, transparent operation of the financial institutions of a given country. In Ethiopia too, the NBE (the central bank), has been legislating different legislations and directions on reserve and liquidity requirements so as to ensure smooth and health operation of the banking sector and other

financial institutions. Normally, banks should prefer to hold smaller amount of their deposit as reserve and lend or invest the rest. Benefits of the sector are generated from credit and/or investment. Since, the lower the reserve requirement, the higher the chances for banks to earn larger interest income, banks are normally expected to have no excess reserve or at least lower and declining excess reserve ratio.

As can be seen from the following figure and table, there has been a persistent and high excess reserve and liquidity in the Ethiopian banking sector. As the figure below shows the excess liquidity and reserve ratio curves are consistently higher, though there has been fluctuation over some time. The difference between the actual reserve/liquidity ratio curves and excess/liquidity/ ratio curves shows the officially required reserve/liquidity ratios.

Figure 12: Excess Reserve and Liquidity Position of Ethiopian Commercial Banks, 1993-2009



Source: National Bank of Ethiopia (NBE)

For the period 1993-2009, the average ratios for actual and excess reserve were 19% and 13%, respectively. For long period of time the official reserve ratio remained at 10% which after April 2008, was then raised to 15%, and to 20% recently to control money supply in view of the recent experience of high inflation in the country. Despite the fact that the official reserve requirements were high, there has been an excess reserve ratio of about 13%. Banks do complain about the fact that the official reserve requirement is too high and yet, paradoxically one observes persistent excess reserve.

Table 15: Excess reserves and liquidity of the Ethiopian Banking sector

Reserve/Liquidity ratios	2002	2003	2004	2005	2006	2007	2008	2009-3quarters	Average (1993-2009)
Actual Reserve Ratio (Actual/Net Deposit*100}	12.2	14.9	22.5	33.9	20.4	21.7	22.3	26.1	19.1
Required Excess Reserve Ratio (excess/net deposit*100)	7.2	9.9	17.5	28.9	15.4	14.0	8.5	11.1	12.8
Actual Liquidity Ratio (Liquid/Net Current Deposit*100}	47.5	65.5	67.6	65.0	59.7	57.2	42.9	44.1	48.4
Excess Liquidity Ratio(Excess/Net Current Deposit)	32.5	50.5	52.6	50.0	44.7	42.2	20.2	19.1	32.3
Liquidity Requirement Ratio (Liquidity Requirement/Net Current Deposit*100	15.0	15.0	15.0	15.0	15.0	15.0	22.7	25.0	16.0

Source: National Bank of Ethiopia (NBE)

Similarly for the period 1993-2009, one observes persistent excess liquidity that ranges between 19% and 53%, and with an average of 32%. Taking the recent years, excess liquidity reached about 53% in 2004 and seems to decline about 20% in 2008. This indicates the fact that the banking sector has been persistently holding idle money while the Ethiopian economy has not been in a position to quench its thirsty for credit and investment.

There is an inherent dilemma in the Ethiopian banking sector. Domestic saving in general and private saving in particular has been consistently low in the country. This would suggest the fact that something should be done to increase saving in the country. Banks should introduce innovative saving instruments to increase saving. They should consider and learn from other countries and intimately understand the problems and behaviors of different economic agents of the Ethiopian economy to mobilize private saving.

Yet, one observes excess liquidity of the banking sector throughout the entire period. One reason could be the supply of credit is exceeding the demand for credit in the Ethiopian economy. If indeed, demand is falling short to absorb the supply of credit, the direction

would be to encourage investment. This has not been the case in Ethiopia. The overall consistent saving-investment gap, indeed shows the fact that there has been supply problem not demand problem. In a development-deficit economy like that of Ethiopia, the challenge is to mobilize adequate resource and its efficient utilization to supply diverse goods and services to the local market and export to generate foreign exchange which has been in short supply throughout.

The plausible reason should be the governance problem of the banking industry, weak supervision and the fact that the nascent financial sector which shoulders such inefficient banking institutions. If the banks can make easy profit with such excess reserves and liquidity why would they be motivated to extend their credit?

The financial institutions in general and the banking sector in particular emerged from a situation where the state-owned banks, which were "operating on a soft budget, failed to develop the capacity for risk assessment and monitoring of their loan portfolio (Nissanke, and Ernest, 2006:6).

Evolving from this legacy, the private sector has emerged in a local market situation where there has been low competition and low supply of banking services. In this regard, Nissanke and Earnest were categorical to assess the performance of African banking sector, which appears quite relevant to the Ethiopian banking industry.

> *"There was neither active liquidity and liability management nor any incentive to increase efficiency, often resulting in increased costs of financial intermediation. The regime of financial repression discouraged banks from investing in information capital, crucial for the development of financial systems. Institutions have typically been burdened with severe agency problems in dealing with idiosyncratic risks, that is, the problems caused by costly and imperfect information such as adverse selection, moral hazard, and contract enforcement." (Nissanke, and Ernest, 2006:6)*

One possible reason for excessive liquidity could be the high risk of default and hence high rate of non-performing loans. This could be one reason that forces the sector to be excessively risk averse. That is in fact the reason, why commercial banks despite their excessive liquidity they are not venturing to project financing, focusing rather on short term financing.

The major factors for high non-performing loans and high liquidity could be the lack of database on credit information that banks could rely on to critically assess the behavior and performance of their clients. So far there has not been credit information that could have critically served the industry to manage their outstanding credits and entertaining potential customers. So what is happening, is the while the economy is thirsty of credit, the commercial banking is having it in excess.

So the strategic direction should be to address the major bottlenecks of the sector in channeling credit to the Ethiopian economy.

3.5 Concluding points on financial development and private saving mobilization

The Ethiopian financial sector is at its best nascent, despite its long history. It remained stunted for long except for the recent growth. The country is under-banked with limited outreach. There is no capital market so far, which could have substantially contributed to attract savings and efficiently allocate investment.

There has never been any change in the instruments of saving, except saving and time deposits. Reflecting on the experience of the East Asian countries and others, it would have been possible to introduce different saving instruments. Unfortunately there has never been the incentive to innovate new saving instruments and increase savings.

In Ethiopia, there has been simultaneously excess reserve and liquidity on the one hand and persistent and substantial short fall of saving on the other hand. One of the institutions that should contribute to fill the saving-investment gap is the financial sector,

which has to be aggressive and innovative to mobilize saving and channel it to investment. What is happening is passive saving mobilization, excessive liquidity, and hence the already small saving is being held idle. The economy desperately needs investment and yet there is idle money in the banks. It is like you are thirsty for water and there is water on the table and yet you cannot quench yourself.

The strategic directions should therefore be to promote aggressive saving using existing and new saving instruments on the one hand and reduce over liquidity of the banking sector.

In order to increase saving, the Ethiopian government should pursue different strategies. One is awareness creation to minimize expensive festival, marriage and mourning ceremonies. The government may bring about different non-government forces mainly religious organizations to enhance saving consciousness.

Moreover, the financial sector should develop alternative markets and instruments that can enhance saving and investment. Gradual introduction of capital market, which may start from government bond appears timely move. Developing the capital market requires will and commitment of the government. Fostering capital market is a complex process that requires intimate understanding of how capital markets operate and what can be learned from the rest of the world. In addition to learning from the rest of the world, one needs to be institutionally innovative to understand the capacity, problems and prospects of the Ethiopian institutional set up. That may help to design a capital market that is tailored to the realities of the country. Offhand, nurturing capital markets requires systemic transformation and capacity development of the macroeconomic system, government behavior and commitment including strong legal and regulatory system.

In such an attempt to develop the financial sector, there is a need for developing innovative instruments to blend the formal with the informal financial institutions. There are quite important informal financial institutions that have to be integrated with the

formal sector, which could be a win-win scenario for both the formal and informal financial sectors.

On the other hand, the central bank of the country should identify the underlying causes for over liquidity in the banking sector and promote credit and investment in the country. One direction could to investment on relevant capacity building areas to mitigate the bottlenecks that hinder smooth operation of the credit market, credit information, ensuring rule of law and minimize the chances for default.

3. Operating business environment

Financial liberalization and macroeconomic stability are only necessary condition for the smooth operation of the economy and sustainable growth and development. These changes need to be complemented by quite strong legal system. The political and legal system should ensure civil liberties and property rights, efficient and predictable judicial system. The legal system provides the legal framework for designing and implementing of contracts between contracting parties. The legal system should provide retail customers and tax payers with protection (Chami, et al, 2009:14).

The formal financial institutions require conducive business/investment/ climate, which involve different types of institutional capacity. Successful operation of all financial institutions requires strong legal systems, well established property rights and efficient regulatory body, which can provide different public services consistent with international norms.

After all, the globe has become flat, giving wider opportunities for investment across different countries. Thus the benchmark is international competitiveness in providing essential services, including contract enforcement, tax administration, protection of investors, establishing property rights and ensuring smooth and efficient transfer of property.

According to the World Bank's Doing Business Indicators, using a legal framework index, SSA in general and Ethiopia in particular is rated lowest compared to countries from the other continents. This suggests that much has to be done to create appropriate business environment.

Relevant indices of the 'Doing Business' ratings of the World Bank are summarized in the following table.

Table 16: Ethiopia's rankings in doing business 2009

Rank	Doing Business 2009 ranking out of 181 countries
Ease of doing business	116
Starting business	118
Registering property	154
Getting credit	123
Protecting investors	113
Paying taxes	37
Enforcing contracts	78
Closing a business	74

Source: The World Bank, 2008: 2.

Out of the 181 countries covered Ethiopia's position is less desired in many aspects of indicators of business climate. In terms of paying taxes Ethiopia's position appears on the positive side, 37 out of the 181 countries. Apart from paying taxes, Ethiopia's position is far from the desired level to ensure competitive climate for overall business, investment and particularly financial development.

4.1 Getting Credit

One of the legal indices is the credit access index, which measures the availability of credit information and the legal rights of both lenders and borrowers. In this regard, there are no public or private credit registries in Ethiopia. So banks will have to decide by themselves without any information about the credit history of business firms and individuals. Indeed, one of the problems that the banks are facing in Ethiopia is the fact

that individuals manage to take credit from different banks at the same time, without due assessment of their financial capacity to service their debts. There is such level of vulnerability of the banking sector in Ethiopia, due to information asymmetry between the lender and borrower.

This could have widen up the market opportunities of banks, which would stimulate them to make maximum marketing effort to attract saving and motivate them to innovate mechanisms to attract the informal financial market in the country.

4.2 Protecting Investors

If there were well developed stock market, individuals should not necessarily put their money in saving deposit. They could consider to buy shares from companies they like invest in. The major blocks in Ethiopia in this regard, are the fact that there is no such stock market. Moreover, the investors have less confidence upon the legal protection for investors.

In this regard, Ethiopia is rated 113th country out of the 181 countries along the globe. The Investor Protection Index has been at 4.3 for the period 2007-2009, showing there is no improvement from such low rating out of ten.

4.3 Enforcing contracts

The mobilization of saving, lending and borrowing functions of banks is essentially contractual. Thus the healthy operation of banks is critically dependent upon the state of contract enforcement in a given country.

Efficient and smooth enforcement of contract facilitate for impersonal market relationship, giving legal ground to market agents to operate in a wider markets. This in turn fosters profitability of banks and other business persons. In this regard, Ethiopia is rated 78th country for the years, 2008 and 2009. Of the three measurement indices, the time and financial cost is discouragingly high. It takes 690 days to enforce a contract, costing 15.2% of the value of the claim.

These indicators of the business climate, which focus on the regulatory system of the country, show the fact that much remains to be desired. In view of the fact that Ethiopia has to ensure its global competitiveness, much has to be done to ensure conducive legal system.

4. Conclusion and policy implications

Despite the disheartening structural constraints of the Ethiopian economy, the recent growth episode and poverty reduction are lights of hope into the future. However, there is this challenge of ensuring sustainability of the recent experience and if possible to enhance it further.

The level of domestic saving has been quite low, leaving the sustainability of the recent encouraging growth history vulnerable to the availability, access and conditionalties of external resources.

Despite the different types of structural impediments, there is wide opportunity to enhance domestic saving. There are a number of institutional constrains that has been inhibiting the country from attaining the achievable in mobilizing domestic financial resources. These institutional constraints are amenable to change, if there is will and commitment to develop the necessary institutional and organizational capacity of both tax collection and financial institutions.

In general, the tax effort of the country has been very low. Taking inter period/regime/ comparison, Ethiopia's tax effort has been not only low but decreased in the recent past years. The tax effort was expected to improve given the fact that the post-1992 growth performance is by far greater than the pre-1992 period. In fact, the average growth rate of the pre-1992 was negative against a population growth rate of about 3%. The average growth of 1995-2000 was about 3% and the growth rates of the recent period since 2004 were double digit, greater than 10%.

Particularly the performance of direct taxes has been low throughout. Out of the total direct taxes, the contribution of business profit taxes remained very low without any visible trend of improvement. Despite the rapidly increasing resource flow to the private sector, in terms of credit and tax exemptions, business profit tax has remained low.

The contribution of the largest sector, agriculture has remained marginal throughout for long period of time. It has rather decreased in the recent past. In view of the fact that the sector still remains dominated by subsistence farming, though it might be difficult to expect substantial improvement of this tax, its contribution should have improved over time, as it is also a beneficiary of the recent growth process.

There has been substantial tax exemption, meant to encourage investment. The government's attempt to encourage investment is commendable. But it is timely to undertake an impact analysis of such instrument. Though there should be time lag, given the fact that investment has been increasing since 1992, it should have a positive impact on government tax revenue at this point in time.

Illegal trade has remained a serious problem in the country. In fact there are widely known corridors of illegal trade, the main being the Easter part of the country, mainly the Somali Regional State of Ethiopia. The problem of illegal trade is complex that calls for development intervention to curb illegal trade in that corridor. For significantly large part of the people illegal trade has remained as the single important source of livelihood. So curbing this illegal trade requires changing the source of livelihood of these people. In addition to such development endeavors to diversify livelihood of the needy agents of illegal trade, the government should strengthen its institutional capacity to control or at least minimize illegal trade.

These observations suggest the fact that it is timely to examine the tax system, which may cover the rates, identification of tax payers, tax assessment and collection system. One possible explanation for low and decreasing tax effort is high tax evasion, which may be attributed to corruption and low organizational capacity of the tax administration of the country. There is encouraging tax reform effort, but it needs to be further strengthened and that should be sustainable. In general, increasing tax collection efficiency and strong measures against illegal trade could increase the tax effort substantially in the near future.

Concerning pension the recent initiative to administer the fund independently as an autonomous entity is commendable. There are concerns that the present pension rate of

the civil servants of 10% is not adequate to ensure social security of the elderly. Moreover, much remains to be done to ensure compulsory pension system including the private sector. These improvements will bring about substantial increase of the pension fund. Yet, unless it is properly administered, it will remain used inefficiently. So far there are narrow opportunities for investment of pension funds due to the absence of capital market in the country. The development of the financial sector in terms of diversifying its services and the development of capital market focusing on bond markets and secondary markets provide wider opportunity for pension funds.

There are large Ethiopian migrants living in different parts of the world. So remittance remains one source of domestic financial resource mobilization, which can and should be tapped. Developing different saving instruments could increase saving out of remitted money. The fact that the NBE(central bank of the country) has allowed for opening up of foreign account at this time is commendable to motivate the Diaspora to invest and remit money to the country. Utmost effort should be exerted to encourage investment of the remitted funds.

There are study results that show the fact that SSA, among which Ethiopia is on, is indeed, net creditor owing to high capital flight. The direction should be to address the very incentive to save and invest abroad. This requires ensuring continual macroeconomic stability and sustainable peace and stability. It is timely for undertaking dedicated research to further understand the underlying causes and mechanisms of capital flight from the country.

One of the major factors that have been hindering full mobilization of domestic saving in general and private saving in particular is the embryonic stage of the financial sector, which is supposed to play a critical role in mobilizing private saving. It remained stunted for long except for the recent years. The country is under-banked with limited outreach. The banking sector provides the traditional banking instruments only. There is no capital market so far, which could have substantially contributed to attract savings and efficient allocation of investment.

There has been low effort to mobilize saving. There has never been any change in the instruments of saving, except saving and time deposits. Reflecting on the experience of the East Asian countries and others, it would have been possible to introduce different saving instruments. The banking sector could have been aggressive to boost savings. So far, low saving is not a reported problem of the country's banking sector. Indeed, in view of the excess liquidity and reserve of the sector, there cannot be an immediate interest to aggressively mobilize private saving. Thus, there has been simultaneously excess reserve and liquidity in the Ethiopian banking industry on the one hand and persistent and substantial macro-level short fall of saving on the other hand. Excessive liquidity implies the fact that the already small saving is being held idle. The economy desperately needs investment and yet there is idle money in the banks. It is like you are thirsty for water and there is water on the table and yet you cannot quench yourself.

The strategic directions should therefore be to make aggressive effort to mobilize saving using existing and new saving instruments on the one hand and reduce excess liquidity of the banking sector.

In order to increase saving, governments should pursue different strategies. One could be awareness creation to minimize expensive festivals, marriage and mourning ceremonies. The government may bring about different non-government forces mainly religious organizations to enhance saving consciousness of the public. This is so because amidst poverty there is extravagant festive culture in the country.

Moreover, the financial sector should develop alternative markets and instruments that can enhance saving and investment. Gradual introduction of capital market, which may start from government bonds appears timely.

In such an attempt to develop the financial sector, there is a need for developing innovative instruments to blend the formal with the informal financial institutions. There are quite important informal financial institutions that have to be integrated with the formal sector, which could be a win-win scenario for both types of financial institutions.

There is good size of credit market that is not being captured by the formal financial market. There are legally and illegally operating financial markets, where the formal markets were oblivious to the informal sector so far. The appreciation of the need to recognize and think of unconventional institutional mechanisms to mobilize these informal sectors could enhance saving.

The majority of the population is living in rural Ethiopia, a sector where there is at best very limited access to financial institutions. To complement the micro financing institutions, there is a need for institutional innovation to mobilize saving from the majority of the small farmer and urban poor. No matter of the magnitude of saving capability of these people, the mere size of the population warrants for innovative measures to effectively reach it. The financial sector has to develop saving instruments which are effective to reach the poor farmer but at the same time with lower transaction cost.

On the other hand, the central bank of the country should identify the underlying causes for over liquidity in the banking sector and promote credit and investment in the country.

One strategic direction is to develop the institutional capacity of the financial sector, where there is a modest beginning. The country needs to be more aggressive to invest on relevant capacity building areas to mitigate the bottlenecks that hinder smooth operation of the credit market, credit information, ensuring rule of law and minimize the chances for default.

Strengthening the monitoring and supervision and well-developed system of accountability is another avenue for improvement.

Figure 13: DRM Matrix: A summary of prospects and constraints of domestic financial resource mobilization

DRM elements	Constraints	Prospects
Domestic financial resource mobilization	Structural constraints	Recent growth episodes and poverty reduction from about 44% to 39% Major infrastructural works in the last decade; education, health, road, power, telecommunication
Low tax effort	Ineffective & inefficient tax collection system	Recognition of the problem of low tax effort
	Corruption	An ongoing tax payers identification
	High tax evasion	Reorganization of the tax collection organization outside the civil service system, higher salary scale
	Low identification of taxpayers	Business process reengineering (BPR) and studies to introduce business score card
	Low tax assessment capacity	
	Low tax administration: delays	
	High tax exemption	Investment has increased though not accompanied by an improvement in tax effort
	Porous border & illegal trade	
Pension	Rate, coverage, pension fund use and allocation: No universal coverage, particularly not yet introduced in the private sector, low rates, narrow investment opportunities	After long period of procrastinations, independently organized, Initiations to establish capital market,
Remittance	Less leverage to determine outcome, affected by international shocks, challenge to convert it to productive allocation,	Increasing flow of remittances, Large size of Diaspora
Capital flight	Sources and mechanisms of capital flight less known Preliminary indicators it is a serious problem	Minimizing it could save substantial resources
Private saving/financial sector development	Low out reach of banks, under banked	An ongoing Studies by NBE to establish capital markets
	Low saving effort	An ongoing project to establish institutional capacity of the sector: credit register database,
	Excess liquidity Vs low saving	

	No capital market	
	Moneylenders	
	No attempt to integrate the informal financial institutions into the formal financial institutions	

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6. Annexes

Annex I: Domestic Saving and Investment 1961/62-2008/09 (in million Birr)

Year(G.C)	Gross capital formation (Investment)	Gross domestic saving	Domestic saving as % of Nominal GDP	Investment as % of nominal GDP
	INV	DSAV	Saving ratio	Investment ratio
1961/62	668.2	757.2	21.20	**18.71**
1962/63	730.7	792.4	21.30	19.64
1963/64	762.4	808.5	20.86	19.67
1964/65	870.0	963.1	22.71	20.51
1965/66	950.6	1,072.8	23.30	20.64
1966/67	1,087.9	1,075.0	21.57	21.83
1967/68	1,170.5	1,221.0	23.13	22.18
1968/69	1,218.3	1,324.2	23.60	21.72
1969/70	1,231.7	1,313.7	22.13	20.74
1970/71	1,160.8	1,352.3	20.92	17.96
1971/72	1,255.7	1,332.4	19.46	18.34
1972/73	1,366.0	1,467.6	21.25	19.78
1973/74	1,289.4	1,715.0	23.78	17.88
1974/75	1,243.5	1,767.6	22.25	15.65
1975/76	1,313.0	1,218.3	15.30	16.49
1976/77	1,154.0	1,213.8	14.26	13.55
1977/78	1,270.4	1,036.6	10.63	13.03
1978/79	1,235.3	618.2	6.01	12.01
1979/80	1,583.0	1,003.5	8.73	13.76
1980/81	1,934.3	1,176.7	9.63	15.83
1981/82	2,087.8	1,468.2	11.76	16.73
1982/83	2,225.0	1,212.4	9.20	16.89
1983/84	2,193.0	1,239.4	8.50	15.04
1984/85	2,826.9	1,712.1	12.58	20.77

1985/86	2,129.3	708.0	4.39	13.20
1986/87	3,399.6	2,251.4	13.39	20.22
1987/88	3,428.7	2,101.4	11.79	19.24
1988/89	4,674.9	3,590.2	19.36	25.21
1989/90	3,466.2	2,691.1	13.80	17.78
1990/91	3,208.5	2,567.0	12.32	15.40
1991/92	3,049.4	1,269.6	5.34	12.83
1992/93	2,919.2	1,202.0	4.67	11.34
1993/94	5,792.4	2,872.4	8.70	17.54
1994/95	6,558.6	2,741.9	7.82	18.69
1995/96	8,506.6	4,839.2	11.53	20.27
1996/97	9,782.6	5,099.7	10.85	20.82
1997/98	10,767.4	6,142.5	11.96	20.97
1998/99	12,882.8	4,703.1	8.00	21.91
1999/2000	13,516.3	5,998.3	9.00	20.28
2000/01	14,594.3	6,802.7	10.00	21.45
2001/02	15,924.7	3,993.4	6.00	23.93
2002/03	16,040.4	2,937.3	4.00	21.84
2003/04	22,070.0	4,333.0	5.00	25.47
2004/05	24,482.6	3,156.0	2.96	22.99
2005/06	31,893.7	4,795.4	3.64	24.23
2006/07	42,650.0	10,836.3	6.31	24.82
2007/08	52,080.6	7,882.6	3.21	21.21
2008/09	66,663.2	14,335.0	4.36	20.27

Source: Ministry of Finance and Economic Development (MoFED),

Annex 2: Money Supply, Narrow and Broad Money, 1970/71 to 2007/08

Year (G.C)	Broad Money supply (M2)	Narrow Money(M1)	Total Money Supply	Ratio of M2 of total Money supply	Annual Growth rate of M2
1970/71	629.6	423.1	1,052.7	59.8	
1971/72	658.2	415.6	1,073.8	61.3	4.54
1972/73	808.0	500.4	1,308.4	61.8	22.76
1973/74	1,066.6	659.4	1,726.0	61.8	32.00
1974/75	1,139.4	489.5	1,628.9	69.9	6.83
1975/76	1,421.8	1,092.8	2,514.6	56.5	24.78
1976/77	1,467.9	996.3	2,464.2	59.6	3.24
1977/78	1,682.2	1,187.2	2,869.4	58.6	14.60
1978/79	1,848.0	1,341.3	3,189.3	57.9	9.86
1979/80	2,053.2	1,443.0	3,496.2	58.7	11.10
1980/81	2,377.6	1,715.3	4,092.9	58.1	15.80
1981/82	2,643.7	1,892.2	4,535.9	58.3	11.19
1982/83	3,040.6	2,180.4	5,221.0	58.2	15.01
1983/84	3,383.7	2,379.3	5,763.0	58.7	11.28
1984/85	3,849.0	2,692.1	6,541.1	58.8	13.75
1985/86	4,448.3	3,179.6	7,627.9	58.3	15.57
1986/87	4,808.7	3,563.5	8,372.2	57.4	8.10
1987/88	5,238.7	3,910.8	9,149.5	57.3	8.94
1988/89	5,704.4	4,173.8	9,878.2	57.7	8.89
1989/90	6,708.2	4,990.0	11,698.2	57.3	17.60
1990/91	7,962.2	6,134.8	14,097.0	56.5	18.69
1991/92	9,011.0	6,845.3	15,856.3	56.8	13.17
1992/93	10,136.7	7,580.7	17,717.4	57.2	12.49
1993/94	11,598.7	8,373.2	19,971.9	58.1	14.42
1994/95	14,408.5	9,922.4	24,330.9	59.2	24.23
1995/96	15,654.9	9,917.4	25,572.3	61.2	8.65
1996/97	16,548.8	10,024.0	26,572.8	62.3	5.71
1997/98	18,643.2	11,094.0	29,737.2	62.7	12.66
1998/99	19,399.3	11,378.9	30,778.2	63.0	4.06
1999/2000	22,177.8	13,050.3	35,228.1	63.0	14.32

2000/01	24,516.2	13,745.8	38,262.0	64.1	10.54
2001/02	26,292.1	14,152.5	40,444.6	65.0	7.24
2002/03	29,060.2	15,416.8	44,477.0	65.3	10.53
2003/04	33,626.0	18,036.0	51,662.0	65.1	15.71
2004/05	40,211.7	21,291.1	61,502.8	65.4	19.59
2005/06	46,377.4	23,811.9	70,189.3	66.1	15.33
2006/07	56,651.9	29,617.7	86,269.6	65.7	22.15
2007/08	68,182.1	35,350.4	103,532.5	65.9	20.35

Source: National Bank of Ethiopia (NBE)

Annex 3: Number and capital of insurance industry as of December 2008.

No. and names of Insurance companies		Branch as of Quarter II of 2008/09			Capital as of Quarter II of 2008/09	
		AA	Regions	Total	(In Million Birr)	Share from total
1	Ethiopian Insurance Corporation	11	27	38	238.8	39.13
2	Awash Insurance Company S.C	13	9	22	50.9	8.34
3	Africa Insurance Company S.C	6	7	13	67.0	10.98
4	National Insurance Company of Ethiopia	8	7	15	14.8	2.43
5	United Insurance Company S.C	13	6	19	44.8	7.34
6	Global Insurance Company S.C	4	3	7	20.3	3.33
7	Nile Insurance Company S.C	10	9	19	50.2	8.23
8	Nyala Insurance Company S.C	8	8	16	64.5	10.57
9	Nib Insurance Company S.C	12	6	18	47.5	7.78
10	Lion Insurance Company S.C	6	4	10	7.3	1.20
11	Ethio-Life Insurance S.C	-	-	-	4.3	0.70
	TOTAL	91	86	177	610.3	100.00

Table 4: Number of Bank Branches and Capital as of the 2nd quarter of 2008/09

Banks	Establishment Year	Branches (in number)				Capital as of 2nd quarter of 2008/09			
		Regional urban centers	Addis Ababa (AA)	Total	% share from total	(in Million Birr)	Share of capital from total	Share of capital Si=xi/X	square of Si
1 Public banks									
Commercial Bank of Ethiopia	1963	160	49	209	35.07	4,560	43.42	0.43	0.1885
Construction & Business Bank	1994	15	12	27	4.53	196	1.87	0.02	0.0003
Development Bank of Ethiopia	1970	31	1	32	5.37	1,943	18.50	0.19	0.0342
Total public banks		**206**	**62**	**268**	**44.97**	**6,699**	**63.79**	**0.64**	**0.4069**
Awash International Bank	???	28	30	58	9.73	540	5.14	0.05	0.0026
Dashen Bank	1995	25	26	51	8.56	676	6.44	0.06	0.0041
Abyssinia Bank	1996	20	25	45	7.55	421	4.01	0.04	0.0016
Wegagen Bank	1997	26	23	**49**	8.22	**621**	5.91	0.06	0.0035
United Bank	1998	13	23	36	6.04	425	4.05	0.04	0.0016
Nib International Bank	1999	16	26	42	7.05	579	5.51	0.06	0.0030
Cooperative Bank of Oromiya	2004	19	3	22	3.69	151	1.44	0.01	0.0002
Lion International Bank	2006	11	9	20	3.36	188	1.79	0.02	0.0003
Zemen Bank	2008	0	1	1	0.17	95	0.90	0.01	0.0001

Oromia International Bank	2008	0	4	4	0.67	107	1.02	0.01	0.0001
Total private banks		158	170	328	55.03	3,803	36.21	0.36	0.1311
Grand banking sector		364	232	596	100.0	10,502	100.00	1.00	1.0000

Source: NBE, Quarterly Report, 2008/09, Vol 24, Quarter 2,

Annex 5: Private Sector Credit (in Million Birr)

Year(G.C)	Private sector credit	Nominal GDP	Share of credit from GDP(nominal) in %	Annual Growth rate of private credit
1970/71	496.9	6,463.5	7.69	
1971/72	528.1	6,848.2	7.71	6.28
1972/73	571.4	6,906.3	8.27	8.20
1973/74	672.3	7,212.5	9.32	17.66
1974/75	**774.3**	**7,944.3**	**9.75**	**15.17**
1975/76	840.2	7,960.6	10.55	8.51
1976/77	901.4	8,513.5	10.59	7.28
1977/78	1,185.0	9,750.3	12.15	31.46
1978/79	1,528.9	10,289.7	14.86	29.02
1979/80	1,987.2	11,501.1	17.28	29.98
1980/81	595.1	12,218.1	4.87	-70.05
1981/82	638.7	12,482.6	5.12	7.33
1982/83	649.2	13,172.1	4.93	1.64
1983/84	628.3	14,583.6	4.31	-3.22
1984/85	594.7	13,607.9	4.37	-5.35
1985/86	578.0	16,133.0	3.58	-2.81
1986/87	640.1	16,812.5	3.81	10.74
1987/88	758.0	17,822.9	4.25	18.42
1988/89	720.8	18,540.6	3.89	-4.91
1989/90	819.4	19,496.2	4.20	13.68
1990/91	852.3	20,838.3	4.09	4.02
1991/92	897.6	23,772.9	3.78	5.32
1992/93	**1,556.1**	**25,750.4**	**6.04**	**73.36**
1993/94	2,304.8	33,031.9	6.98	48.11

1994/95	4,131.1	35,084.6	11.77	79.24
1995/96	6,175.6	41,965.7	14.72	49.49
1996/97	6,799.6	46,984.8	14.47	10.10
1997/98	8,009.6	51,353.5	15.60	17.80
1998/99	9,578.0	58,788.6	16.29	19.58
1999/2000	10,952.9	66,648.3	16.43	14.35
2000/01	11,704.5	68,026.8	17.21	6.86
2001/02	11,521.7	66,556.6	17.31	-1.56
2002/03	11,764.5	73,432.2	16.02	2.11
2003/04	11,782.4	86,661.0	13.60	0.15
2004/05	13,850.8	106,472.8	13.01	17.55
2005/06	17,138.2	131,641.5	13.02	23.73
2006/07	20,937.4	171,834.5	12.18	22.17
2007/08	25,268.9	245,584.8	10.29	20.69
2008/09	28,849.2	328,809.4	8.77	14.17

Source: Ministry of Finance and Economic Development and National Bank of Ethiopia

Annex 6: Inward Remittance inflow to Ethiopia, 1992/93-2008/09, (in Million USD)

Year	1992/93	1993/94	1994/95	1995/96	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09
Amount	0.3	0.3	0.2	2.3	39.9	104.3	71.3	105.9	104.1	93.4	140.6	211.1	350.8	354.9	632.6	800.3	723.2

Source: NBE