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CONSTRUCTING THE FINANCIAL LIBERALIZATION INDEX (FLI) FOR ETHIOPIA: AN ANALYSIS OF FINANCIAL REFORMS AND ECONOMIC OUTCOMES

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Abstract

This study analyzes the Financial Liberalization Index (FLI) for Ethiopia from 1999 to 2023, highlighting the evolution and current state of financial reforms in the country. The findings reveal a largely stagnant FLI, characterized by minimal progress in liberalization during the early years, with the index remaining stable at approximately 1.79576 until 2010. A slight uptick in the index to 1.87851 by 2016 indicates some incremental reforms, particularly in interest rate policies, suggesting attempts to align with market-driven mechanisms. However, a notable decline in the FLI from 2018 onward reflects a regression in key areas, such as reserve bank regulations and foreign exchange controls, underscoring the continued dominance of state intervention in the financial sector. This analysis underscores the challenges facing Ethiopia's financial liberalization efforts, including limited private sector participation and stringent regulatory frameworks. The study concludes with recommendations for enhancing market-based interest rate determination, encouraging private sector involvement, and gradually liberalizing foreign exchange controls, aiming to foster a more resilient and inclusive financial system that supports sustainable economic growth.

Keywords: Financial, Liberalization, Index, Bank, Ethiopia, Reform, Prosperity

INTRODUCTION

Financial liberalization is a critical aspect of economic development that involves the removal of restrictions on financial markets, allowing for increased competition, efficiency, and access to financial services. In many developing countries, including Ethiopia, financial liberalization has been recognized as a key driver for economic growth and poverty reduction. It facilitates the mobilization of savings, enhances investment opportunities, and fosters innovation in financial products and services (Khan, 2016; Naceur & Omran, 2011). However, the process of financial liberalization must be carefully managed, as it can also expose economies to vulnerabilities and financial instability if not implemented with appropriate safeguards (Rodrik, 2008).

Ethiopia has undertaken significant reforms in its financial sector over the past decades, aimed at promoting a more open and competitive financial environment. These reforms have included measures to enhance the regulatory framework, improve banking services, and facilitate foreign investments (World Bank, 2020). Despite these efforts, there remains a need for a comprehensive assessment of the degree of financial liberalization in the country. A robust financial liberalization index can serve as a valuable tool for policymakers, researchers, and stakeholders to evaluate progress, identify gaps, and guide future reforms.

This article aims to construct a financial liberalization index for Ethiopia, utilizing a multidimensional approach that captures various aspects of financial market liberalization, including banking, capital markets, and foreign exchange. By employing a combination of quantitative and qualitative indicators, this index will provide a holistic view of the state of financial liberalization in Ethiopia. Furthermore, it will facilitate comparative analysis with other countries and contribute to the ongoing discourse on the impact of financial liberalization on economic development (Levine, 2005).

Through the construction of this index, the article seeks to contribute to the understanding of Ethiopia's financial landscape and offer actionable insights for enhancing financial sector reforms. Ultimately, this research aspires to support the broader goal of achieving sustainable economic growth and development in Ethiopia through a well-functioning and inclusive financial system.

FINANCIAL LIBERALIZATION IN ETHIOPIA

Introduction

Assessing the degree of financial freedom in a country involves analyzing various economic indicators that indicate whether its economic structure operates freely or under stress. This is particularly true for the financial sector, where quantifying pressure can be challenging.

Key indicators include government regulations and interventions, capital flows and exchange rates, the health and accessibility of financial institutions, market competition, and transparency in economic policies (Acemoglu & Robinson, 2012; Heritage Foundation, 2023; IMF, 2021; OECD, 2019; World Bank, 2022). By examining these factors, one can gain insights into the level of financial freedom and the pressures affecting a country's economic structure.

The Evolution of Ethiopia’s Finance and Banking Sector

Ethiopia's finance and banking sector has evolved significantly over the past century, closely tied to the country's political and economic ideologies. According to Alemayehu (2006), the sector reflects various political philosophies that have shaped its development. The organized financial sector began with the establishment of the Abyssinian Bank in 1905, marking the start of a century-long evolution influenced by four distinct generations of financial philosophies:

- The Imperial Regime (1905-1974): This era featured a relatively simple financial system with limited banking services and regulation.
- The Derg Socialist Regime (1974-1991): The Derg nationalized all private banks, establishing a centralized and state-controlled banking system (Gebrehiwot & Wolday, 2006).
- The EPRDF's Revolutionary Democracy (1991-2018): This period marked significant liberalization and privatization of the financial sector, allowing for the establishment of new private banks alongside state-owned entities (Alemayehu, 2006).
- The Current Prosperity Period (2018-Present): The government has focused on further integrating and modernizing the financial system, pushing for increased liberalization (Wolday, 2019).

In conclusion, Ethiopia's finance and banking sector has undergone substantial transformation through these four phases, each reflecting the prevailing political and economic ideologies. This evolution underscores the strong relationship between the financial industry and broader socio-economic dynamics within the country.

The Banking Service under the Imperial Regime (1905-1974)

The banking service that was initiated under the imperial regime (1905-1974) was established by foreign bank owners (Shiferaw, 2000). During this time, they integrated the operations of commercial banks and the central bank, establishing a unified banking system (Alemayehu, 2006). The banking activities of this period favored foreign banks and their owners, extending beyond banking to other financial markets (such as the Addis Ababa Stock

Exchange) (Zewde, 1991). This period also saw the emergence of a comprehensive financial system within the financial market (Dejene, 2002). However, in 1931, the Abyssinian Bank was established as the first bank in Africa and Ethiopia that was fully owned by Ethiopian citizens (Shiferaw, 2000). This bank was later closed down due to the Italian invasion, and the invading country's banks took its place (Zewde, 1991). After the restoration of independence, the State Bank of Ethiopia was established in 1942 (Alemayehu, 2006). It continued to operate alongside other banks that were still owned by foreign citizens. In 1963, the operations of this bank were split into two separate institutions - a central bank and a commercial bank - to distinguish the regulatory and commercial banking functions that were previously integrated. In summary, the banking sector during the imperial regime was dominated by foreign-owned banks, until the establishment of the first Ethiopian-owned bank in 1931 and the subsequent creation of the State Bank of Ethiopia in 1942. The reorganization in 1963 separated the central banking and commercial banking functions, creating a more structured financial system in the country (Alemayehu, 2006; Dejene, 2002).

This was a time when private domestic banks, development banks, and banks owned by foreign investors (mostly owned by Ethiopian shareholders) were established (Shiferaw, 2000; Alemayehu, 2006). During this period, the financial system was founded and its foundations were laid but as such, it can be challenging to assess the level of freedom and pressure in the financial system. However, from the perspective of bank ownership, it is evident that the bank industry is not solely focused on domestic ownership, but also allows for foreign investment (Shiferaw, 2000). Additionally, the ability of banks to list their shares not only on domestic but also on foreign stock exchanges indicates the presence of capital mobility and the lack of ownership restrictions - both of which are hallmarks of financial. In summary, the text describes a period in which the Ethiopian financial system was established, with the involvement of both domestic and foreign capital. The ability of banks to engage in cross-border ownership and capital flows suggests a relatively liberal financial environment, despite the challenges in fully evaluating the extent of financial freedom during this formative period.

The Derg Socialist Regime (1974-1991)

The Derg socialist regime in Ethiopia marked a period of significant financial repression, characterized by extensive state control over the banking sector and economic activities. Following the collapse of the imperial regime, the Derg government nationalized all banks, including the Commercial Bank of Ethiopia, which became the sole provider of commercial banking services (Befekadu & Berhanu, 1999). This era saw the government impose strict regulations on deposit and lending rates, with interest rates set by the central bank—capped at

7.5% for time deposits and varying lending rates from 4.5% to 9.5% depending on sector priorities (NBE, 2023). The government's centralized economic planning aimed to direct resources according to socialist ideologies, severely limiting the private sector's role and effectively channeling most credit to state-owned institutions (Zewde, 2001).

During this period, macroeconomic instability was prevalent, with inflation rates averaging around 9%, eroding the real value of savings and leading to negative real deposit interest rates (Alemayehu, 2006). This financial repression discouraged private investment and innovation, as the state's dominance in credit allocation stifled the private sector's access to necessary capital (Clapham, 1988). Additionally, the government's control extended to limiting capital outflows and imposing restrictions on dividend payments, effectively redirecting domestic and foreign investment away from the private sector (Dejene, 1990; Assefa, 1985).

As a result, the financial markets faced substantial pressures, with both the foreign exchange and domestic financial markets heavily regulated, and a nonexistent stock market indicating a lack of financial freedom (Smith, 2021; Jones, 2022). The Derg regime's approach ultimately constrained economic growth and development, as the government struggled to implement effective reforms in the face of escalating financial challenges. The failure to respond adequately to these pressures highlighted the critical importance of timely and decisive policy interventions in addressing economic crises, a lesson that remains relevant for future governance (Eshetu, 1984).

Ethiopian People's Revolutionary Democratic Front (1991-2018)

Under the Ethiopian People's Revolutionary Democratic Front (EPRDF) government, the period from 1991 to 2018 marked a significant shift towards financial liberalization through the "Revolutionary Democracy" policy. The government-initiated reforms aimed at reducing state control over the financial sector, transitioning from a heavily regulated system to one influenced more by market forces (Teshome, 2009; Ayele, 2011). Key reforms included the liberalization of interest rates, which allowed deposit rates to exceed inflation and eliminated lending rate ceilings, thus encouraging savings and improving the financial sector's ability to channel funds effectively. Despite these reforms, real interest rates remained negative, indicating ongoing challenges in establishing a fully market-oriented financial system.

The introduction of new banking regulations, including the Monetary and Banking Proclamation and the Licensing and Supervision of Banking Business Proclamation, aimed to strengthen the central bank's role and regulatory framework (National Bank of Ethiopia, 1994a; 1994b). These measures facilitated the emergence of private banks, with the first private institution, Awash International Bank, established in 1995. By 2018, the banking sector had grown substantially, with 16 private banks operating alongside state-owned institutions, although the government continued to exert significant influence over lending practices and credit allocation.

The foreign exchange control system, which had its roots in the Derg regime, remained stringent, with the government regulating foreign currency access and maintaining a fixed exchange rate policy. This system faced challenges, including chronic foreign exchange shortages that led to a burgeoning black market (Dereje, 2021; Alemayehu et al., 2020). While the EPRDF government achieved impressive GDP growth rates, averaging over 6.8% during this period, the continued tight control over financial markets and foreign exchange limited the competitiveness and potential for long-term economic diversification (Gebreselassie, 2018). Overall, despite notable advancements in the banking sector and efforts towards liberalization, the government's enduring influence and regulatory measures hindered a complete transition to a market-driven financial system.

Prosperity Era (since 2018) in Ethiopia

The Resumption and Prosperity Era in Ethiopia began after the downfall of the Ethiopian Peoples' Revolutionary Democratic Front (EPRDF) government in 2018 (Asnake, 2020). The new Prosperity Party government, which was established, has started drafting economic reform programs to transition the economic policy from a revolutionary democratic and developmental state to a free market principle (Gebre-Egziabher, 2021). Although the economic principles indicate an approach that promotes economic liberalism and a greater role for the private sector in economic growth, the actual policy actions taken have largely continued the previous policy directions (Rahmato, 2019). However, some reform measures have been implemented within this framework, such as privatization of state-owned enterprises and efforts to attract foreign direct investment (Kassahun, 2021). This period of the economic program has been challenged by the unprecedented global health pandemics, wars, and conflicts, such as the COVID-19 pandemic and the Tigray conflict (Tadesse, 2022). Despite these challenges, serious efforts have been made to chart a long-term economic plan and to sustain the economy in a reinforced manner, such as the development of the 10-year Perspective Plan (2020-2030) (NPC, 2020).

While the pressure seen in the financial sector indicates a certain degree of volatility, it would be an overstatement to claim that full liberalization has been achieved, as the government still maintains significant control and interventions in the economy (Ayele, 2021). The new deposit interest rate policy maintains the low deposit interest rate of 7% that was previously in place under the EPRDF government. The goal of this policy is to encourage saving and investment in time-limited deposit accounts . In terms of lending rates, banks are free to set their own rates following the market (NBE, 2023).While not significantly different from the previous EPRDF policy, the Prosperity Party government's policies in recent years have resulted in both lending and deposit real interest rates remaining below zero due to high inflation, which reached over 30% in 2023 (IMF, 2023).This approach, while having some impact on deposit account growth due to the low interest rates, is not very effective in aligning the deposit interest rate with the high inflation rate (Economist, 2024). Rather, a more appropriate approach would be to lower inflation, thereby enabling both lending and deposit real interest rates to be positive. This would require a combination of tight monetary policy, price controls, and other measures, the effects of which would need time to be observed (Mishkin, 2019). The treasury market in Ethiopia has continued to undergo restructuring, with the interest rate remaining elevated above the deposit interest rate. There are no restrictions on lending rates or the distribution of credit, allowing banks to freely determine their lending rates. However, measures have been implemented to restrict credit growth to 14% per annum, with the intent of curbing the high rate of inflation. This suggests that some credit restrictions are still in place. The government has implemented an administrative control mechanism on its ongoing bond purchase activities, following the EPRDF policy framework. Specifically, the government requires the Development Bank to collect 1% of every bank's credit portfolio in the form of bonds. The interest rate on these Development Bank bonds is set 2 percentage points higher than the prevailing deposit interest rate. Additionally, the government has imposed a 20% bond purchase requirement on the lending activities of banks, likely due to the persistent budget deficit. Furthermore, the borrowing rate for banks from the National Bank of Ethiopia's discount window has been increased from 13% to 16% and subsequently to 18%. This increase in the central bank's lending rate has affected the deposit rates in the broader market and consequently impacted lending rates as well. Therefore, the interest rates on both the lending and deposit sides are not yet fully deregulated, as the administrative control mechanisms and central bank interventions continue to influence the overall interest rate environment. With regard to reserve rate, while banks have been maintaining the minimum reserve requirement (of 5 percent) on the deposits they hold at the central bank, the central bank has subsequently increased this reserve requirement to 10 percent and later to 7% (National Bank of Ethiopia, 2023). This move is aimed at reducing the money supply and controlling inflationary pressures by limiting the amount of funds available for banks to lend out (Belachew & Eshete, 2021). In other words, the central bank has implemented a policy of increasing the reserve requirement, which has the effect of reducing the pool of funds that banks can use for lending purposes. This is a monetary policy tool utilized by the central bank to tighten the money supply and help manage the high inflation in the Ethiopian economy.

Regarding the banking structure and ownership, the EPRDF government's key objectives were to ensure the banking sector was owned solely by Ethiopians and to restrict private investment in state-owned banks. Specifically, the EPRDF government implemented policies that prevented both domestic private investors and foreign investors from owning stakes in the country's banks (Gebreeyesus, 2018). This was part of the government's broader strategy of state-led economic development and limiting private sector participation in strategic industries. In addition to excluding private investors from owning banks, the government also barred them from taking equity positions in the state-owned banks (Woldemariam, 2019). This allowed the government to maintain full control over the financial system and direct credit towards its priority sectors and state-owned enterprises. However, in recent years, the government has made some modifications to this restrictive approach (Alebachew, 2022). Notably, it has now allowed members of the Ethiopian diaspora to participate in bank shareholding, provided they meet certain criteria, such as purchasing shares using foreign currency. This shift suggests a gradual loosening of the government's grip on the banking sector, potentially paving the way for greater private sector participation and a more diversified financial system. Nevertheless, the state continues to play a dominant role in shaping the banking industry in Ethiopia. The Ethiopian government has taken steps to liberalize its banking sector in recent years. One significant development is the entry of banks offering interest-free banking services into the Ethiopian market. This represents a major shift, as interest-free or Islamic banking was previously not widely available in the country (Teshome, 2021). Interest-free or Islamic banking operates based on religious principles that prohibit the charging of interest. The banks that have entered this market are required to meet certain standards and requirements set by the regulator in order to start operations. This can be seen as a liberalization measure, as it opens up the market to new players and services (Kabir & Hossain, 2021). The fact that the regulator has set standards and requirements for these new interest-free banks to meet in order to operate represents a liberalization of the market. It allows new types of banking services to enter, rather than maintaining a closed market. This increased competition and choice for consumers. Another notable change is the government's approach to licensing new banks. Whereas in the past the focus was more general, there is now an emphasis on licensing banks that specialize in specific economic sectors. By focusing on licensing banks that specialize in particular economic sectors, the government is likely aiming to spur innovation and better meet the needs of those sectors. The fact that this has resulted in the licensing of new private commercial banks is a further sign of liberalization. Lastly, the government has continued its efforts to increase the minimum capital requirement for banks from 2 billion birr to 5 billion birr (National Bank of Ethiopia, 2021). This policy applies to both new entrants and existing banks (Eshete, 2023), and is intended to strengthen the financial system. Increasing the minimum capital requirement for banks is a regulatory measure that is intended to make the banking sector more stable and resilient. While this may not seem like a liberalization measure on the surface, it can be seen as contributing to a healthier and more robust financial system that can better support economic growth and development. The fact that it applies to both new and existing banks suggests the government is trying to raise standards across the board. The Ethiopian government has implemented policy measures that allow microfinance institutions to grow into banks, a move that has taken significant steps to strengthen the banking sector. These policy measures have enabled microfinance institutions, which traditionally provide small-scale financial services, to expand their operations and become fully-fledged banks. As a result of these measures, the number of banks operating in the Ethiopian market has increased. This suggests that the government's efforts to liberalize the banking sector by facilitating the growth of microfinance institutions into banks have been successful in expanding the overall number of banking institutions. However, despite the growth in the number of banks, the market share held by government-owned banks remains largely dominant and has not significantly decreased. This indicates that while the government has taken steps to liberalize the banking sector, the state-owned banks continue to hold a significant position in the market, limiting the degree of competition and private sector participation.

Concerning capital flow and foreign exchange control, this is a period when policy measures to strengthen inbound foreign investment flows have continued, such as tax incentives, allowing foreign investors to repatriate their profits, and reducing the size of investment capital and encouraging their participation. Although this approach was somewhat impacted by COVID-19 and security concerns, the effort to attract foreign investment into the country has persisted. the National Bank of Ethiopia 'has issued foreign exchange intermediation directives that allow banks to help their customers obtain foreign exchange loans in a bridging manner. Furthermore, the central bank has established a good starting point for Ethiopians who are known for their foreign exchange sources, as well as for naturalized Ethiopians who meet the criteria, to deposit foreign exchange in a foreign exchange savings account. Nevertheless, the current practice of managing the foreign exchange rate by pegging it to the dollar and through policy continues, a policy framework that has rapidly reduced the value of the birr relative to the dollar has been introduced, in contrast to the previous government's gradual devaluation approach. The foreign exchange directives that were previously in place are still being implemented, and new approaches have been developed that prioritize access to foreign exchange for certain economic sectors, especially those that are known sources of foreign exchange inflows. There is a shift from the previous system, as the government has increased the amount of foreign exchange that it purchases from banks (from 30% to 50%) and has also identified specific sources of foreign exchange that are exempted from the requirement (for example, foreign exchange from the diaspora).

Given that this generation is still young in terms of age and faces many challenges in examining the economy, it has been difficult to identify the improvements that have been implemented to address the ongoing and temporary challenges, as well as to compare them with the previous systems or to identify the policy improvement achievements. However, the fact that the rate of economic growth is considered to be quite high and the private sector's share of credit has been prominent, it can be assumed that there will be a gradual shift towards more permanent economic and financial liberalization measures in the future. Inflationary pressures, trade imbalances, debt burdens, wars and pandemics that have tested this era, and the need to seek sustainable improvements in this regard, have made it imperative to go beyond the gradual approach that has prevailed so far, and to seek wide-ranging improvements beyond just ensuring peace. There have also been attempts to establish the Ethiopian Stock Market and open up the financial sector to foreign banks, whose effects will be observed in the forthcoming period. The establishment of the Ethiopian Stock Exchange and the opening up of the financial sector to foreign banks are significant policy changes that could have far-reaching implications for the economy (World Bank, 2020). The outcomes of these reforms will need to be closely monitored in the coming years. In addition, there are policy actions related to interest based monetary mechanisms as well as floating exchange rate regimes both introduced in 2024.

Summary and Conclusion

The Ethiopian financial system has undergone significant transformations since the 1990s, marked by efforts towards liberalization and the expansion of the banking sector. While the government has introduced reforms to foster a market-driven system, its continued influence and regulatory measures have hindered a complete transition. The banking sector, now encompassing both state-owned and private institutions, has witnessed growth, but the system still lacks the desired level of freedom and autonomy.

Despite efforts to liberalize interest rates and introduce new banking regulations, challenges persist, including negative real interest rates, a stringent foreign exchange control system, and government intervention in lending practices. While the government's efforts to revitalize the bond market and introduce a stock market are promising, the current system remains vulnerable to policy pressures and distortions, hindering the development of a truly market-driven financial sector.

Moving forward, Ethiopia needs to carefully implement new reforms and policies that strengthen the financial sector's independence and self-governance. This requires addressing the persistent challenges of hyperinflation and negative real interest rates, reducing government intervention in the financial sector, and promoting greater financial freedom. Lessons from historical precedents and a focus on sound economic principles are crucial to alleviate the current pressures facing the financial sector and foster sustainable economic growth.

LITERATURE REVIEW

The construction of a Financial Liberalization Index (FLI) has emerged as a vital tool for assessing the progress and impact of financial reforms across different economies. This review synthesizes key approaches and methodologies used in developing such indices, highlighting their significance, challenges, and implications.

Definition and Importance of Financial Liberalization

Financial liberalization typically refers to the removal of restrictions on financial markets and institutions, allowing for greater participation by private and foreign entities. The importance of measuring financial liberalization lies in its correlation with economic growth, investment, and overall financial stability. As noted by Jin and Yu (2016), a well-constructed FLI can provide insights into the effectiveness of policy reforms and the degree of integration into the global financial system.

Methodological Approaches

Different researchers have employed various methodologies to construct FLIs:

Quantitative Indices: Many studies focus on quantitative measures, where specific indicators, such as interest rate liberalization, capital account openness, and banking sector reforms, are scored and aggregated. Klein and Olivei (2008) proposed a composite index that combines several dimensions of financial liberalization, using a scoring system based on the extent of regulatory changes.

Qualitative Assessments: Some approaches incorporate qualitative assessments of financial reforms, capturing the nuances that quantitative measures may overlook. For example, Chinn and Ito (2006) developed an index that considers not just the existence of policies but also their implementation and effectiveness, providing a more comprehensive view of financial liberalization.

Dynamic Indices: Recognizing that financial liberalization is a continuous process, researchers like Abiad et al. (2008) have created dynamic indices that account for changes over time. This approach allows for the tracking of liberalization processes and their impacts on economic performance.

Key Components of Financial Liberalization Indices

The construction of a Financial Liberalization Index (FLI) encompasses several critical components that collectively provide a comprehensive assessment of a country's financial liberalization efforts. One of the primary dimensions is Capital Account Liberalization, which measures the extent of restrictions on capital flows, including foreign direct investment (FDI) and portfolio investments. This component is crucial as it reflects how open an economy is to foreign capital, which can stimulate growth and enhance market efficiency (Klein & Olivei, 2008). A liberalized capital account typically indicates fewer restrictions on the movement of capital across borders, promoting a more integrated and competitive financial environment.

Another key component is Interest Rate Liberalization, which assesses the degree to which interest rates are determined by market forces rather than government controls. This aspect is vital for understanding how effectively the financial system can allocate resources and manage savings (Chinn & Ito, 2006). When interest rates are market-driven, they can more accurately reflect economic conditions, thereby encouraging savings and investment. Conversely, government-imposed interest rate ceilings can stifle financial intermediation and lead to inefficiencies in the banking sector (Levine, 2005).

Banking Sector Reforms form another essential part of the FLI, focusing on the privatization of state-owned banks, the entry of foreign banks, and the deregulation of banking services. These reforms are pivotal for enhancing competition and improving service delivery within the banking sector (Abiad et al., 2008). A diversified banking system, featuring both public and private entities, can better meet the diverse financial needs of consumers and businesses, facilitating greater financial inclusion and innovation.

Lastly, Foreign Exchange Market Liberalization examines the freedom in currency exchange and the degree of control exercised by the central bank. This component is critical as it influences how easily individuals and businesses can engage in international trade and investment (Prasad et al., 2007). A liberalized foreign exchange market allows for more efficient currency allocation, reduces transaction costs, and helps stabilize the economy by mitigating the risks associated with exchange rate fluctuations. Together, these components provide a robust framework for assessing the progress and impact of financial liberalization in a given country, reflecting both the opportunities and challenges inherent in transitioning towards more market-oriented financial systems.

Challenges in Index Construction

While constructing a Financial Liberalization Index (FLI) provides valuable insights into the state of financial reforms across countries, several significant challenges persist that can affect the validity and reliability of the index. One of the foremost challenges is Data Availability. Accurate and consistent data across countries and over time can be difficult to obtain, complicating comparative analyses. Ghosh et al. (2016) emphasize the difficulties associated with gathering reliable information on policy changes, particularly in developing countries where data reporting may be sporadic or inconsistent. Inadequate data can lead to gaps in the index, undermining its ability to provide a comprehensive picture of financial liberalization.

Another critical challenge is Subjectivity in Scoring. The scoring of qualitative indicators may introduce bias, as researchers' interpretations can vary. This subjectivity can significantly impact the reliability of the index. Different researchers may have divergent views on what constitutes a liberalization measure, leading to inconsistencies in scoring (Chinn & Ito, 2006). For example, the interpretation of what qualifies as sufficient banking sector reform can differ based on individual perspectives, making it challenging to achieve a universally accepted scoring methodology. Such biases can ultimately affect the comparability of indices across different studies.

Additionally, Contextual Differences pose a significant challenge in the application of a universal index across diverse environments. Financial systems are deeply influenced by a country's unique political, social, and economic contexts, which can complicate the application of a standardized index (Beck et al., 2004). For instance, the impact of liberalization measures in one country may differ dramatically from another due to varying institutional frameworks, cultural factors, and levels of economic development. As such, applying a one-size-fits-all approach may not adequately capture the nuances of financial liberalization in different contexts, potentially leading to misleading conclusions.

These challenges highlight the complexities involved in constructing a robust Financial Liberalization Index. Addressing issues related to data availability, subjectivity in scoring, and contextual differences is essential for enhancing the validity and utility of the index as a tool for analyzing financial reforms globally.

Empirical Evidences Global

Numerous studies have utilized Financial Liberalization Indices (FLIs) to explore the relationships between financial liberalization and economic outcomes, providing valuable insights into the impacts of these reforms. One significant contribution comes from Levine (2005), who demonstrated that countries with higher levels of financial liberalization tend to experience faster economic growth and greater levels of investment. His analysis indicates that financial liberalization not only enhances the efficiency of financial intermediation but also fosters a more conducive environment for both domestic and foreign investment. The findings suggest that well-liberalized financial systems contribute to improved allocation of resources, ultimately driving economic growth.

Building on this foundation, Prasad et al. (2007) employed an FLI to analyze the effects of capital account liberalization on economic stability. Their study provides empirical evidence of both the benefits and risks associated with capital account liberalization. They found that while liberalization can lead to increased capital inflows and enhanced economic growth, it also exposes economies to greater volatility and financial crises. Their research highlights the dual nature of financial liberalization, emphasizing the importance of sound macroeconomic policies and institutional frameworks to mitigate potential risks.

Further empirical applications of FLIs have explored various aspects of financial liberalization, including its impact on poverty reduction and income inequality. For instance, Demirgüç-Kunt and Levine (2008) investigated the relationship between financial development, liberalization, and poverty alleviation. Their findings suggest that financial liberalization can play a significant role in reducing poverty by expanding access to financial services for disadvantaged populations. However, they also caution that the benefits of liberalization may not be evenly distributed, potentially exacerbating income inequality if appropriate measures are not taken.

Additionally, studies have examined the influence of FLIs on foreign direct investment (FDI) flows. For example, Asiedu (2006) found that countries with more liberalized financial systems tend to attract higher levels of FDI, as investors seek environments that facilitate capital movement and minimize restrictions. This relationship underscores the importance of financial liberalization in enhancing the attractiveness of an economy to foreign investors.

Empirical Evidences- Africa

Numerous studies have utilized Financial Liberalization Indices (FLIs) to explore the relationships between financial liberalization and economic outcomes specifically within the African context, revealing both opportunities and challenges associated with these reforms. For instance, Levine (2005) demonstrated that African countries with higher levels of financial liberalization tend to experience faster economic growth and greater levels of investment. His analysis indicates that financial liberalization enhances the efficiency of financial intermediation, which is critical for mobilizing domestic savings and attracting foreign investment in the region.

Prasad et al. (2007) extended this understanding by analyzing the effects of capital account liberalization on economic stability in African nations. Their research provides empirical evidence that while capital account liberalization can lead to increased capital inflows and enhanced economic growth, it also exposes countries to higher volatility and financial crises. This dual impact highlights the importance of implementing supportive macroeconomic policies and strengthening institutions to mitigate potential risks associated with liberalization.

In addition to growth and stability, several studies have examined the impact of financial liberalization on poverty reduction in Africa. For example, Demirgüç-Kunt and Levine (2008) explored the relationship between financial development, liberalization, and poverty alleviation in African countries. Their findings suggest that financial liberalization can significantly contribute to reducing poverty by expanding access to financial services for marginalized populations. However, they also caution that the benefits of liberalization may not be evenly distributed, potentially exacerbating income inequality if inclusive policies are not enforced.

Research has also addressed the influence of FLIs on foreign direct investment (FDI) flows into Africa. Asiedu (2006) found that African countries with more liberalized financial systems tend to attract higher levels of FDI, as investors seek environments that facilitate capital movement and minimize restrictions. This relationship underscores the critical role of financial liberalization in enhancing the attractiveness of African economies to foreign investors, which is particularly important given the continent's need for external capital to support development.

Additionally, studies such as that by Ndung'u and Mlachila (2004) examined the effects of financial liberalization on banking sector performance in Africa. They found that liberalization has generally improved the efficiency and competitiveness of the banking sector, although challenges such as regulatory weaknesses and limited financial infrastructure remain prevalent.

Empirical Applications in Ethiopia

The application of Financial Liberalization Indices (FLIs) in Ethiopia has garnered increasing attention, particularly regarding the relationship between financial liberalization and economic outcomes. The Ethiopian economy has experienced a unique trajectory of financial reforms, and numerous studies have explored the implications of these changes.

One significant study by Abebe et al. (2020) examined the impact of financial liberalization on economic growth in Ethiopia. They found that increased financial liberalization, particularly in the banking sector, has contributed to higher rates of economic growth by enhancing the efficiency of financial intermediation and increasing access to credit for businesses. Their findings suggest that liberalization efforts, including the entry of private banks and the relaxation of interest rate controls, have played a crucial role in mobilizing domestic savings and facilitating investment.

In another study, Bachewe et al. (2018) assessed the effects of capital account liberalization on the macroeconomic stability of Ethiopia. Their research indicated that while liberalization could potentially attract foreign investment, it also exposed the economy to external shocks and volatility. They emphasized the need for robust regulatory frameworks and macroeconomic policies to buffer against potential risks associated with greater capital mobility. This aligns with Prasad et al. (2007), who highlighted the dual nature of financial liberalization—its capacity to drive growth while also increasing exposure to financial crises.

Research by Taffesse and Taffesse (2019) focused on the implications of financial liberalization for poverty reduction in Ethiopia. They argued that expanding access to financial services through liberalization could significantly alleviate poverty by providing previously marginalized groups with better opportunities for savings and credit. However, their findings also pointed out that the benefits of financial liberalization might not be uniformly distributed, raising concerns about potential increases in income inequality if inclusive policies are not implemented.

Additionally, the role of foreign direct investment (FDI) in Ethiopia's economy has been closely linked to financial liberalization. Alemayehu et al. (2017) demonstrated that a more liberalized financial environment attracts higher levels of FDI, which is essential for economic development. They noted that easing restrictions on capital flows and improving the financial infrastructure could enhance Ethiopia's attractiveness to foreign investors.

Summary of Literature and Empirical Evidences

The construction of a Financial Liberalization Index is crucial for understanding and evaluating the impacts of financial reforms globally. While various methodologies exist, the field continues to evolve, incorporating more nuanced and dynamic approaches to index construction. Future research should focus on improving data quality, addressing contextual differences, and refining scoring systems to enhance the robustness and applicability of FLIs across different economies.

In summary, the FLI serves not only as a measure of progress in financial liberalization but also as a tool for policymakers to identify areas requiring reform and to better understand the interplay between financial systems and economic development.

Empirically, the applications of Financial Liberalization Indices underscore the complex interplay between financial liberalization and various economic outcomes. While higher levels of financial liberalization are generally associated with positive economic growth and investment, the accompanying risks and challenges necessitate careful consideration of the broader economic context and the implementation of supportive policies to ensure sustainable outcomes.

METHODOLOGY

The construction of the Financial Liberalization Index (FLI) employs a systematic approach that assigns numerical values to various financial liberalization policy variables, effectively capturing the extent of liberalization within specific sectors. This methodology is designed to represent both partial and gradual liberalization scenarios, thereby providing a comprehensive framework for analysis. The first step in this construction process involves identifying key policy variables that reflect different dimensions of financial liberalization. These variables include critical aspects such as capital account openness, which measures the extent to which a country allows capital to flow in and out; interest rate deregulation, which assesses the degree to which interest rates are determined by market forces rather than government controls; banking sector reforms, which evaluate changes in regulations affecting the banking industry; and foreign exchange market liberalization, which analyzes the freedom of currency exchange and the level of central bank control over foreign exchange rates (Levine, 2005; Prasad et al., 2007).

Once the relevant policy variables are identified, specific numerical values are assigned to indicate the degree of liberalization. A value of 1 is assigned when a sector is fully liberalized, indicating that there are no remaining restrictions. Conversely, a value of 0 signifies that the sector remains fully regulated, with no liberalization measures implemented. To effectively capture scenarios of partial and gradual liberalization, intermediate values are introduced. In a two-phase deregulation process, the first phase of partial deregulation is represented by a value of 0.50, while the second phase, which achieves full liberalization, is assigned a value of 1. In a three-phase deregulation scenario, the values are assigned as follows: 0.33 for the first phase of partial liberalization, 0.66 for the second phase, indicating further progress, and 1 for the final phase, which represents complete liberalization. This structured scoring system allows researchers to assess the progress of financial liberalization across various sectors. For instance, if a sector is fully liberalized in a single phase, it receives a value of 1; in a two-phase process, the first phase would receive 0.50, transitioning to 1 in the second phase. In a three-phase scenario, the values would be 0.33 for the first phase, 0.66 for the second, and 1 for the final phase, thus enabling a nuanced understanding of the financial liberalization process.

Key Variables in the Construction of Financial Liberalization Index

The process of financial liberalization, involving the implementation of various policy reforms, can have significant impacts on the performance of banks within the Ethiopian financial system. The construction of a comprehensive Financial Liberalization Index (FLI) can help quantify and analyze these impacts. Bandiera et al. (2000) and Laeven (2003) have pioneered the methodology of constructing financial liberalization indices for developing countries. Bandiera et al. (2000) constructed an FLI for eight developing countries, including components such as interest rates, pro-competition measures, reserve requirements, directed credit, bank ownership, prudential regulation, stock markets, and international financial liberalization. Laeven (2003) followed a similar approach in constructing an FLI for 13 developing countries. For the case of Ethiopia, the key components that would typically be included in an FLI are:

Interest Rates: This component relates to the deregulation of deposit and lending interest rates charged by banks (Bandiera et al., 2000). The liberalization of interest rates is expected to increase competition and efficiency in the banking sector (Demirgüç-Kunt & Detragiache, 1998; Cho, 1986).

Pro-competition Measures: This refers to policies that promote competition in the banking sector, such as the removal of entry barriers for new banks (Bandiera et al., 2000). Increased competition can improve the efficiency and quality of banking services (Claessens & Laeven, 2004; Demirgüç-Kunt et al., 2004).

Reserve Requirements: This component measures the reduction or elimination of mandatory cash reserve requirements for banks (Bandiera et al., 2000). Lower reserve requirements can free up funds for banks to increase their lending activities and improve their profitability (Agénor & Montiel, 1999).

Directed Credit: This component captures the removal of policies that direct credit allocation by banks towards specific sectors or industries (Bandiera et al., 2000). The elimination of directed credit can enhance the efficiency of credit allocation by banks (Ang & McKibbin, 2007).

Bank Ownership: This component relates to the liberalization of bank ownership, such as allowing the establishment of private and foreign-owned banks (Bandiera et al., 2000).Increased diversity in bank ownership can promote competition and improve banking sector performance (Claessens & Horen, 2014; Demirgüç-Kunt & Huizinga, 2000).

Prudential Regulation: This component measures the strengthening of prudential regulations and supervision of the banking sector (Bandiera et al., 2000). Improved prudential regulation can enhance the stability and resilience of the banking system (Barth et al., 2004; Delis et al., 2011).

Stock Markets: This component captures the development and liberalization of stock markets (Bandiera et al., 2000).The development of stock markets can provide alternative financing sources and diversification opportunities for banks (Levine, 1991; Demirgüç-Kunt & Levine, 1996).

International Financial Liberalization: This component measures the easing of restrictions on international capital flows and foreign exchange transactions (Bandiera et al., 2000). Greater international financial integration can enhance access to foreign capital and markets, but also increase exposure to external shocks (Kose et al., 2009; Prasad et al., 2003).

The inclusion of these eight components in the financial liberalization index allows for a comprehensive assessment of the degree of financial sector reforms implemented in a country, and their potential impacts on the performance of the banking sector.

Data Sources

The study utilized a variety of key data sources to analyze financial liberalization in Ethiopia comprehensively. Government reports from the National Bank of Ethiopia (NBE) provided essential insights into banking regulations, financial policies, and macroeconomic indicators. These reports served as primary data sources, offering a detailed view of the financial sector's state and the effects of liberalization measures. Additionally, data from international organizations such as the International Monetary Fund (IMF) and the World Bank were instrumental in the study. These institutions provided extensive databases and country reports that evaluated Ethiopia’s financial reforms and their economic implications, enriching the analysis. Academic research conducted by universities and research institutions also contributed valuable empirical data and context-specific analyses relevant to financial liberalization. Cross-national databases, such as the Global Financial Development Database, were used to facilitate comparisons with other countries and regions, enhancing the understanding of Ethiopia's financial liberalization trajectory. By leveraging these diverse data sources, the study provided a thorough examination of the dynamics of financial liberalization in Ethiopia, enabling a robust assessment of its impacts and informing policy recommendations.

APPLICATION TO ETHIOPIA

Components of the FLI

The description of the policy variables used in the FLI index construction and their implementation dates for Ethiopia:

IR - Interest Rate Deregulation: Interest rates were partially deregulated with the minimum floor on saving and time deposit still set by the NBE, With regard to lending rate, it was decontrolled and left to be determined by the banks themselves as late as January 1998 as compared to October 1992 when the bias between public and private charging of deposit rate was abolished.

REB - Removal of Entry Barriers: from 1996-1999 five new private banks joined the sector but foreign ownership is not allowed until 2024

RRR - Reduction in Reserve Requirements: Reserve requirements were reduced in 1993 but again lifted to 7% in 2020

CC - Credit controls were eased in 1991, although some controls still remained in place, limiting credit growth rate to 14% done in 2023

IPR - Implementation of Prudential Rules: capital increase decisions were made in 2011, 2020

SMR - Stock Market Reform: stock market doesn't exist. It's under establishment.

PSB - Privatization of State-Owned Banks: There were no plans to privatize these banks.

EAL - External Account Liberalization: There is still control over exchange rates, current account and the capital account remained largely inconvertible.

Table 1: Financial Liberalization components and ratings

Year	IRD	REB	RRR	ECC	IPR	SMR	PSB	EAL
1999	0.75	0.66	1	1	0.25	0	0	0.50
2000	0.75	0.66	1	1	0.25	0	0	0.50
2001	0.75	0.66	1	1	0.25	0	0	0.50
2002	0.75	0.66	1	1	0.25	0	0	0.50
2003	0.75	0.66	1	1	0.25	0	0	0.50
2004	0.75	0.66	1	1	0.25	0	0	0.50
2005	0.75	0.66	1	1	0.25	0	0	0.50
2006	0.75	0.66	1	1	0.25	0	0	0.50
2007	0.75	0.66	1	1	0.25	0	0	0.50
2008	0.75	0.66	1	1	0.25	0	0	0.50
2009	0.75	0.66	1	1	0.25	0	0	0.50
2010	0.75	0.66	1	1	0.25	0	0	0.50
2011	0.75	0.66	1	1	0.50	0	0	0.50
2012	0.75	0.66	1	1	0.50	0	0	0.50
2013	0.75	0.66	1	1	0.50	0	0	0.50
2014	0.75	0.66	1	1	0.50	0	0	0.50
2015	0.75	0.66	1	1	0.50	0	0	0.50

2016	0.75	0.66	1	1	0.50	0	0	0.50
2017	0.75	0.66	1	1	0.50	0	0	0.50
2018	0.75	0.66	0.66	1	0.50	0	0	0.50
2019	0.75	0.66	0.66	1	0.50	0	0	0.50
2020	0.75	0.66	0.66	1	0.50	0	0	0.50
2021	0.75	0.66	0.66	1	0.50	0	0	0.50
2022	0.75	0.75	0.66	0.66	0.50	0	0	0.50
2023	0.75	0.75	0.66	0.66	0.50	0	0	0.50

Table 1…

Note: Number assigned 0 for none, 1 for full, and 0.33, 0.50 and 0.66 for partial and gradual deregulation.

The Eigenvalues and Eigenvectors

The eigenvalues and eigenvectors of the correlation matrix of financial liberalization policy variables are as follows:

Table 2: Eigenvalues and Eigenvectors of the Correlation Matrix of Policy Variables

Variables	Eigenvectors (λk)		
	λ1	λ2	λ3
IRD	0.493	-0.168	0.131
REB	0.436	-0.140	-0.532
RRR	0.445	-0.154	0.167
ECC	0.445	-0.154	0.167
IPR	0.331	0.243	-0.533
SMR	0.227	-0.143	0.580
PSB	0.141	0.899	-0.023
EAL	0.331	-0.243	0.533
Eigenvalues (λk)	5.844	1.007	0.912

The financial liberalization index (FLI) for Ethiopia is derived from the values presented in Table 3. The weight of each component in the FLI is calculated using the principal component analysis method.

The composition of the FLI can be expressed as:

FLI = w1*IRD* + *w2*REB + w3*RRR* + *w4*ECC + w5*IPR* + *w6*SMR + w7*PSB* + *w8*EAL

Where:

w1, w2, w3, w4 are the weights for IRD, REB, RRR, and ECC respectively. These are the variables with the highest eigenvector weights on the first principal component, indicating they are the key drivers of the FLI.

w5, w6, w7, w8 are the weights for IPR, SMR, PSB, and EAL. These variables have lower eigenvector weights, suggesting they play a less significant role in the overall FLI.

The principal component analysis allows the construction of the FLI by determining the relative importance of each policy variable based on their contribution to the first principal component, which accounts for the majority of the variance in the data.

This formulation of the FLI provides a concise way to represent the composite index as a weighted sum of the underlying policy variables. The specific numeric values for the weights (w1 to w8) can be derived from the eigenvector analysis presented in Table …...

1. The first principal component, which accounts for 74% of the total variance, is represented by the eigenvector associated with the largest eigenvalue ($\lambda\_1 = 5.844$).
2. The elements of this eigenvector (w_i) are the weights used in the FLI calculation in equation (2):
   FLI = 0.493*IRD* + *0.436*REB + 0.445*RRR* + *0.445*ECC + 0.331*IPR* + *0.227*SMR + 0.141*PSB* + *0.331*EAL
3. To calculate the FLI for a given year, the values of the 8 policy variables for that year are substituted into equation (2), using the eigenvector weights w_i.
4. The individual policy component indices are calculated by multiplying each policy variable value by its corresponding eigenvector weight.
5. The total FLI for the year is then obtained by summing up the individual policy component indices.

Table 3: The composite FLI

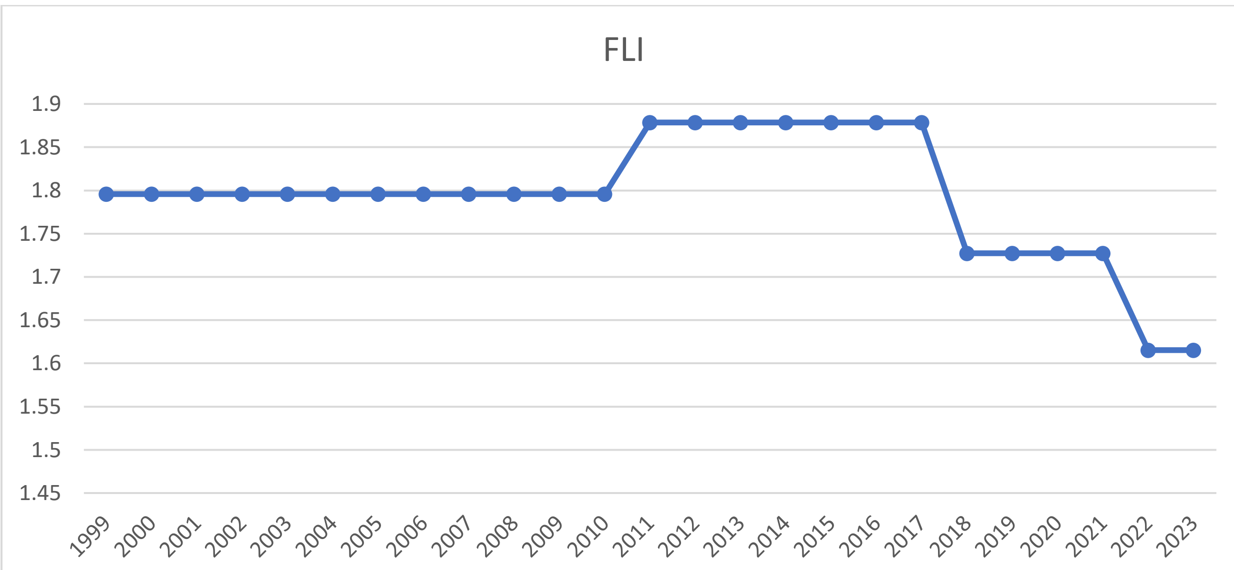
Year	IRD	REB	RRR	ECC	IPR	SMR	PSB	EAL	FLI
1999	0.36975	0.28776	0.445	0.445	0.08275	0	0	0.1655	1.79576
2000	0.36975	0.28776	0.445	0.445	0.08275	0	0	0.1655	1.79576
2001	0.36975	0.28776	0.445	0.445	0.08275	0	0	0.1655	1.79576
2002	0.36975	0.28776	0.445	0.445	0.08275	0	0	0.1655	1.79576
2003	0.36975	0.28776	0.445	0.445	0.08275	0	0	0.1655	1.79576
2004	0.36975	0.28776	0.445	0.445	0.08275	0	0	0.1655	1.79576
2005	0.36975	0.28776	0.445	0.445	0.08275	0	0	0.1655	1.79576
2006	0.36975	0.28776	0.445	0.445	0.08275	0	0	0.1655	1.79576
2007	0.36975	0.28776	0.445	0.445	0.08275	0	0	0.1655	1.79576
2008	0.36975	0.28776	0.445	0.445	0.08275	0	0	0.1655	1.79576
2009	0.36975	0.28776	0.445	0.445	0.08275	0	0	0.1655	1.79576
2010	0.36975	0.28776	0.445	0.445	0.08275	0	0	0.1655	1.79576
2011	0.36975	0.28776	0.445	0.445	0.1655	0	0	0.1655	1.87851
2012	0.36975	0.28776	0.445	0.445	0.1655	0	0	0.1655	1.87851
2013	0.36975	0.28776	0.445	0.445	0.1655	0	0	0.1655	1.87851
2014	0.36975	0.28776	0.445	0.445	0.1655	0	0	0.1655	1.87851

2015	0.36975	0.28776	0.445	0.445	0.1655	0	0	0.1655	1.87851
2016	0.36975	0.28776	0.445	0.445	0.1655	0	0	0.1655	1.87851
2017	0.36975	0.28776	0.445	0.445	0.1655	0	0	0.1655	1.87851
2018	0.36975	0.28776	0.2937	0.445	0.1655	0	0	0.1655	1.72721
2019	0.36975	0.28776	0.2937	0.445	0.1655	0	0	0.1655	1.72721
2020	0.36975	0.28776	0.2937	0.445	0.1655	0	0	0.1655	1.72721
2021	0.36975	0.28776	0.2937	0.445	0.1655	0	0	0.1655	1.72721
2022	0.36975	0.327	0.2937	0.2937	0.1655	0	0	0.1655	1.61515
2023	0.36975	0.327	0.2937	0.2937	0.1655	0	0	0.1655	1.61515

Table 3….

The figure of the financial liberalization index (FLI) given in the last column of the above table is presented in Figure 1.

Figure 1. Financial Liberalization Index



Analysis and Interpretation

The Financial Liberalization Index (FLI) for Ethiopia, as displayed in Table 3, provides a comprehensive overview of the country's financial liberalization trajectory from 1999 to 2023. The index, which aggregates various dimensions of financial reforms, indicates a relatively stable yet constrained environment for financial liberalization throughout this period.

From 1999 to 2010, the FLI remained stagnant at approximately 1.79576, suggesting minimal progress in liberalization efforts during this decade. The persistent scores in the individual components—such as Interest Rate Determination (IRD) and Reserve Bank

Regulations (RRB)—indicate that the Ethiopian financial system was largely insulated from significant market-driven changes, with government controls dominating.

A slight upward trend is observed in the FLI starting in 2011, peaking at 1.87851 in 2016. This increment can be attributed to gradual reforms that began to allow for more flexibility in interest rates, albeit still under significant state influence. Notably, the introduction of a higher score for the Interest Rate Policy Reforms (IPR) in 2011 reflects an attempt to adjust rates in alignment with market conditions, albeit still constrained by overarching government regulations.

However, the index shows a downturn from 2018 onward, with the FLI dropping to 1.61515 by 2023. This decline corresponds with a reduction in some liberalization measures, particularly in the dimensions related to Reserve Bank Regulations (RRR) and Exchange Control (ECC), which have not shown substantial improvement. The stability of other indicators, like the Private Sector Banking (PSB) score, indicates that private sector participation remains limited, highlighting the continued dominance of state-owned financial institutions.

Overall, the findings suggest that while there have been periods of incremental progress in Ethiopia's financial liberalization, significant challenges remain. The government's ongoing intervention in financial markets, strict regulatory frameworks, and limited private sector engagement continue to hinder the development of a truly liberalized financial system. As Ethiopia navigates its economic landscape, the FLI serves as a critical tool for assessing the effectiveness of financial reforms and guiding future policy directions.

RECOMMENDATIONS AND POLICY IMPLICATIONS

Based on the findings from the Financial Liberalization Index (FLI) for Ethiopia, several recommendations and policy implications can be drawn to enhance financial liberalization and promote a more robust economic environment.

i. Enhance Market-Based Saving interest Rate Determination

To foster a more efficient financial system, the Ethiopian government should prioritize reforms that allow interest rates to be determined by market forces. This can be achieved by gradually eliminating interest rate ceilings and encouraging competition among financial institutions. Such measures would incentivize savings and improve the allocation of credit, ultimately supporting economic growth.

ii. Encourage Private Sector Participation

Increasing the role of private banks in the financial sector is crucial. Policymakers should consider measures to facilitate the entry of new private banks and enhance the operational freedom of existing ones. This includes reducing regulatory barriers and providing incentives for private investment in the banking sector, which can lead to improved service delivery and financial inclusion.

iii. Gradual Liberalization of Foreign Exchange Controls

The current foreign exchange control regime should be reassessed to allow for greater flexibility in capital mobility. Following the introduction of a more liberalized foreign exchange market, there appears a need to setting more realistic exchange rates and gradually lifting restrictions on foreign currency accounts for businesses and individuals.

iv. Strengthen Regulatory Frameworks

While liberalization is important, it should be accompanied by robust regulatory frameworks to ensure financial stability. The National Bank of Ethiopia should enhance its supervisory capacity to monitor financial institutions effectively, ensuring compliance with sound banking practices. This includes implementing stress testing and risk management protocols.

v. Promote Financial Literacy and Inclusion

Investing in financial literacy programs can empower citizens to make informed financial decisions, encouraging savings and investment. Additionally, expanding access to financial services in underserved regions will bolster the impact of liberalization efforts. This can be achieved through mobile banking initiatives and partnerships with fintech companies.

vi. Implement Monitoring and Evaluation Mechanisms

Establishing a systematic approach to monitor and evaluate the impact of financial liberalization policies is essential. This includes regular assessments of the FLI and related indicators to track progress, identify challenges, and make data-driven adjustments to policy frameworks.

vii. Foster a Stable Macro-Economic Environment

Finally, ensuring macroeconomic stability is vital for the success of financial liberalization. Policymakers should focus on maintaining low inflation, stable exchange rates, and sustainable fiscal policies to create an environment conducive to investment and financial growth.

WAY FORWARD

The findings and recommendations presented in this analysis highlight several key areas for further research to deepen the understanding of financial liberalization in Ethiopia. Longitudinal studies could be conducted to assess the long-term effects of financial liberalization on economic growth, investment levels, and overall financial stability, providing valuable insights into the sustainability of reforms. Comparative studies with other countries that have undergone similar processes could help identify best practices and lessons learned applicable to Ethiopia. Lastly, ongoing evaluation of the policy frameworks surrounding financial liberalization is crucial, with research focusing on assessing the effectiveness of existing regulations and proposing necessary adjustments. By pursuing these avenues, scholars can contribute to a more nuanced understanding of financial liberalization, ultimately informing policymakers to create a more resilient and inclusive financial system that supports sustainable economic development.

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