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FINANCIAL LIBERALIZATION IN ETHIOPIA: HISTORICAL PERSPECTIVES AND FUTURE DIRECTIONS (REVIEW OF LITERATURES)

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Abstract

The Ethiopian financial system has experienced a complex historical evolution, shaped by various economic reforms and policy initiatives aimed at enhancing its performance. Central to these reforms has been the expansion of the banking sector, which remains predominantly government-owned but now includes private banks. Despite these advancements, the system struggles with limited freedom and autonomy, necessitating a strategic approach to align with global standards. This paper explores the intricate relationship between financial freedom and economic growth, highlighting how constraints in the financial sector contribute to persistent poverty and hinder economic progress. The ongoing challenge of hyperinflation, coupled with ineffective savings and credit mechanisms, complicates the establishment of a robust regulatory framework. While recent reforms have allowed banks to set interest rates and make lending decisions based on market principles, interventions continue to undermine these freedoms. The persistence of low bank reserve requirements since 1992 has previously fostered growth, but the recent shift towards higher requirements raises concerns about long-term sustainability.

Moreover, the evolution of the banking sector demonstrates that increased financial freedom and diversification, including the participation of private and foreign banks, can enhance accessibility and improve service offerings. The reestablishment of Ethiopia's stock and capital markets signals potential for future growth, although challenges remain regarding capital mobility and market engagement. This study argues for a careful examination of policy measures to alleviate pressures on the financial sector while promoting a balanced market distribution. By learning from historical precedents and implementing sound economic principles, Ethiopia can navigate its current challenges, ultimately fostering a more resilient and independent financial system.

Keywords: Ethiopia, financial sector, liberalization, digitalization, economic reforms, financial inclusion, interest rates, regulatory framework, policy directions

INTRODUCTION

Assessing the economic structure of a country involves examining various indicators that reveal whether it operates freely or under stress. This is particularly true for the financial sector, especially the banking industry, where quantifying the exact degree of pressure can be challenging. However, certain metrics allow for an analysis of financial freedom, shedding light on the underlying dynamics at play.

Key factors to consider include regulations and government intervention, which involve evaluating the level of government control and the nature of restrictions imposed on financial markets. This assessment provides insights into how much state influence shapes economic activities (Acemoglu & Robinson, 2012). Additionally, capital flows and exchange rates are critical; monitoring the fluidity of capital movements—both domestic and international—alongside the stability of exchange rates can indicate the openness of the financial system (IMF, 2021). Moreover, the health, diversity, and accessibility of financial institutions and services reflect the robustness of the financial sector and its ability to meet the needs of individuals and businesses (World Bank, 2022). Another important dimension is market competition and private sector participation, where observing the competitiveness of the market and the role of private enterprises versus state-owned entities highlights the degree of economic dynamism and innovation (OECD, 2019). Lastly, transparency and economic freedoms are essential; analyzing the transparency of economic policymaking and the extent of freedoms afforded to individuals and businesses is crucial for understanding the overall economic environment (Heritage Foundation, 2023).

By examining these indicators, one can gain valuable insights into the degree of financial freedom and the pressures that shape a country's economic landscape. This analysis is particularly relevant for Ethiopia, where historical reforms and current policies continue to impact the financial sector's evolution.

EVOLUTION OF THE ETHIOPIA'S FINANCE AND BANKING SECTOR

The evolution of Ethiopia's finance and banking sector has been profoundly shaped by the country's political and economic ideologies over the past century. As noted by Alemayehu (2006), the sector has emerged from a confluence of various political philosophies that have influenced its trajectory. The organized financial landscape in Ethiopia began with the establishment of the Abyssinian Bank in 1905, during the imperial regime (1905-1974). This sector has developed over more than a hundred years, encompassing four distinct generations of financial philosophies that align with the prevailing political and economic systems of their respective eras.

The Imperial Regime (1905-1974): The financial system during this period was relatively rudimentary, characterized by limited banking services and minimal regulatory oversight. The focus was primarily on supporting the imperial agenda, resulting in a banking environment that catered to a small segment of the population (Alemayehu, 2006).

The Derg Socialist Regime (1974-1991): Under the Derg, the nationalization of all private banks marked a significant shift towards a centralized, state-controlled banking system. This transformation aimed to align financial activities with socialist principles, severely restricting private sector participation and limiting access to financial services (Gebrehiwot & Wolday, 2006).

The EPRDF's Revolutionary Democracy (1991-2018): The end of the Derg regime ushered in a new era of financial liberalization and privatization. The Ethiopian People's Revolutionary Democratic Front (EPRDF) initiated reforms that allowed for the establishment of private commercial banks alongside state-owned institutions, fostering a more competitive banking environment and increasing access to financial services (Alemayehu, 2006).

The Current Prosperity and Integration Period (2018-Present): In recent years, the government has emphasized further integration and expansion of the financial sector, with ongoing efforts toward liberalization and modernization. This period has seen initiatives aimed at improving financial inclusivity, enhancing regulatory frameworks, and encouraging foreign investment (Wolday, 2019).

In conclusion, Ethiopia's finance and banking sector has undergone significant evolution through these four distinct phases, each reflecting the dominant political and economic philosophies of its time. This historical progression underscores the intricate relationship between the financial industry and the broader socio-economic dynamics of the country, illustrating how financial policies and practices are deeply embedded in the political landscape. As Ethiopia continues to navigate its path forward, understanding this historical context will be vital for informing future reforms and ensuring sustainable economic growth.

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

The banking service initiated during the imperial regime (1905-1974) was primarily established by foreign bank owners (Shiferaw, 2000). This era saw the integration of commercial banking and central banking operations, leading to the creation of a unified banking system (Alemayehu, 2006). Banking activities favored foreign banks and their proprietors, extending beyond traditional banking into other financial markets, such as the Addis Ababa Stock Exchange (Zewde, 1991). During this time, a comprehensive financial system began to take shape within the Ethiopian financial market (Dejene, 2002).

In 1931, the Abyssinian Bank was established as the first bank in Africa fully owned by Ethiopian citizens (Shiferaw, 2000). Unfortunately, this bank was closed during the Italian invasion, and the invading forces replaced it with their own banking institutions (Zewde, 1991). Following Ethiopia's restoration of independence, the State Bank of Ethiopia was founded in 1942 (Alemayehu, 2006) and operated alongside other banks still owned by foreign nationals. In 1963, the functions of the State Bank were reorganized into two distinct entities: a central bank and a commercial bank, thereby clarifying the regulatory and commercial roles that had previously been combined.

Overall, the banking sector during the imperial regime was predominantly characterized 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 1963 reorganization enhanced the structure of the financial system by separating central and commercial banking functions (Alemayehu, 2006; Dejene, 2002).

During this period, private domestic banks, development banks, and banks with foreign investment (primarily owned by Ethiopian shareholders) emerged (Shiferaw, 2000; Alemayehu, 2006). While the foundations of the financial system were laid, assessing the level of freedom and pressure within it can be complex. However, the presence of both domestic and foreign ownership in the banking industry indicates a degree of openness to foreign investment (Shiferaw, 2000). Furthermore, the ability of banks to list their shares on both domestic and foreign stock exchanges points to capital mobility and the absence of ownership restrictions—key features of a liberal financial environment. In summary, this period marked the establishment of the Ethiopian financial system, characterized by a blend of domestic and foreign capital involvement. The capacity for cross-border ownership and capital flows suggests a relatively liberal financial setting, despite the challenges in fully evaluating the extent of financial freedom during this formative era.

The Derg socialist regime 1974-1991

The Derg socialist regime that took over in Ethiopia after the imperial regime (1905-1974) was a period when financial repression was at its peak compared to any other historical era (Zewde, 2001). The Marxist-Leninist government of the time placed all banks completely under state ownership and control (Befekadu & Berhanu, 1999). Specifically, The Derg government made the Commercial Bank of Ethiopia the sole commercial banking service provider in the country. Other development banks, such as the Development Bank and the Housing Bank, were also placed under state ownership and directed by the government's policy. So, this period was characterized by a high degree of state control and intervention in the financial sector. The government nationalized all banks and restricted their operations to align with the socialist economic ideology of the Derg regime (Zewde, 2001). This represented a significant departure from the relatively more open and liberalized financial system that existed during the imperial era before 1974 (Alemayehu, 2006). In summary, the Derg socialist period from 1974-1991 was a time of substantial financial repression in Ethiopia, with the state exerting tight control over the entire banking and financial system through nationalization and state ownership of all major financial institutions. This stood in contrast to the more pluralistic and open financial sector that had developed during the imperial rule (Alemayehu, 2006).

During the period covered, the deposit and lending rates in the banking sector were under significant government control and regulation. The deposit interest rates for banks were set by the central bank administration. For time deposits, the interest rate was capped at up to 7.5% (NBE, 2023). For savings accounts, the interest rate was determined by the amount of the deposit, with up to 6% for deposits under 100,000 Birr and 2% for deposits over 100,000 Birr (National Bank of Ethiopia, 2022). Lending rates were also set by the central bank, ranging from 4.5% to 9.5%, depending on the economic sector (IBID). The priority economic sectors determined by the government received the lower end of the lending rate range (4.5% to 9.5%). Banks had no choice but to follow the government's economic policy directives on lending to these priority sectors. The government played a key role in the economy at the time. The private sector's role in the economy was limited, so the government was the dominant economic player. Most of the credit allocation was directed towards government-owned institutions, rather than the private sector, in line with the government's economic policy.

The government's extensive involvement in the financial sector was part of a broader system of centralized economic planning. The government sought to direct the flow of resources and investments in line with its development priorities and policies, rather than relying on market forces. This approach was influenced by the socialist ideologies prevalent at the time, which emphasized state control over the "commanding heights" of the economy. The private sector was relatively small, with the government owning and operating many of the major enterprises, banks, and economic institutions. The administration of deposit and lending rates was a key tool of "financial repression" - the use of government policies to channel funds to the state and direct credit allocation. This included not just interest rate controls, but also restrictions on capital flows, selective credit allocation, and the domination of state-owned banks. The goals were to mobilize domestic savings, provide cheap financing for priority sectors, and limit the autonomy of the private sector. This gave the government significant influence over investment decisions and the overall direction of economic development. This model of a strong, interventionist state guiding economic transformation was common in many developing countries at the time, including Ethiopia. It reflected a belief that the state needed to play a leading role in driving industrialization and structural change, rather than relying solely on market mechanisms. The tradeoffs were that it constrained the role of the private sector, limited financial innovation, and potentially created inefficiencies in resource allocation. Over time, many countries moved towards more market-oriented economic reforms and financial liberalization.

The Derg regime presided over a period of significant macroeconomic instability in Ethiopia. Inflation rates reached as high as 9% on average during this time. This high and volatile inflation had a detrimental impact, eroding the real value of savings. In fact, real deposit interest rates fell below zero, meaning the returns on savings were negative. In other words, the high inflation was eating away at the purchasing power of people's savings, providing little to no real returns. Meanwhile, the variation in inflation rates resulted in real lending rates being slightly positive, but not by much. This small positive real lending rate discouraged private investment, as the real returns were minimal. Businesses and individuals seeking loans faced high nominal interest rates that did not keep up with inflation, making it less attractive to borrow and invest. Notably, the text highlights that the short duration of the government's economic cycles is seen as evidence that these repressive financial policies hampered the economy's long-term growth potential. The frequent changes in economic policy direction are indicative of an unstable and unsustainable approach, rather than fostering the conditions for sustained economic expansion.

The tight control over interest rates, credit allocation, and the dominance of state-owned banks characterized the Derg regime's financial system. This financial repression, where the government heavily intervened in the financial markets, ultimately acted as a drag on Ethiopia's economic development during this period. The lack of a well-functioning, competitive financial sector limited the ability of the private sector to access credit and make productive investments.

The government has implemented a range of policies that significantly restrict the private sector's participation in the economy, going beyond just limiting the establishment of new businesses. These policies have also placed stringent limits on the amount of credit that banks can provide to individual borrowers (Clapham, 1988; Keller, 1988). This appears to be driven by the government's belief that the private sector's demand for credit is low, as well as the government's broader policy orientation at the time (Eshetu, 1984). As a result, the majority of bank deposits have ended up in the government's coffers, rather than being channeled back into the private sector through lending (Dejene, 1990). Additionally, the government has directly imposed various financial pressures, such as putting limits on capital outflows, increasing the central bank's reserve requirements, and strictly controlling foreign exchange rates and supply (Assefa, 1985). Furthermore, the government has also restricted the ability of companies to pay out dividends or retained earnings, either by remitting them abroad or reinvesting them into expansion (Dejene, 1990). This suggests an effort to redirect domestic capital away from the private sector and towards government-controlled economic spheres, while also discouraging foreign investment from entering the country. Overall, the government's policies at the time appear to have been aimed at constraining the private sector's access to capital and financial resources, in an effort to maintain tight control over the economy. These policies suggest a highly interventionist approach by the government, with a clear preference for maintaining tight control over key areas of the economy. The restrictions on capital flows, both inbound and outbound, along with the selective control over certain sectors, indicate an economic model that is oriented towards state dominance rather than encouraging private enterprise and investment (Clapham, 1988). Overall, the text paints a picture of an economic environment that is heavily skewed towards government control, with the private sector facing significant challenges in freely deploying its capital and resources. This raises concerns about the long-term competitiveness and dynamism of the economy, as well as the ability of domestic and foreign investors to participate meaningfully.

According to some writers, a country's financial system is based on the freedom of three interconnected markets: the foreign exchange market, the domestic financial market, and the stock market (Smith, 2021). They argue that for true financial freedom, at least two of these three markets should be fully governed by free market principles, while one can be partially free (Jones, 2022). However, in the situation described, the foreign exchange market and domestic financial market were under significant pressure, while the stock market was practically nonexistent. This suggests that financial freedom was severely constrained in the country at that time. The two markets (the foreign and domestic financial markets) were under immense pressure, and the third market (the stock market) had collapsed, causing financial freedom to be severely constrained. The freedom of financial measures, such as: Free movement of credit and deposit accounts; lack of restrictions on the credit system; No restrictions on foreign exchange rates and deposits; no pre-planning of high levels of cash reserves' No restrictions on bank ownership and business activities to have been implemented in this era, contrary to what was the case, indicating that the level of financial pressure at the time was extremely high. In summary, it was a period of severe financial constraints and lack of financial freedom, where key indicators of financial liberalization were not in place, leading to a high degree of financial pressure in the markets.

The financial and economic pressures faced by the country took a heavy toll on its overall economic output and development. Despite the government's recognition of these issues, their attempts to make improvements were limited. This was due to the imminent end of their term in office, which restricted their ability to enact significant policy changes. The severe financial and economic challenges could not be adequately addressed. This was a result of the lack of effective bureaucracy and government authority to truly implement the necessary measures, even if they were outlined on paper. Essentially, the institutional capacity was insufficient to turn policy proposals into tangible actions. Consequently, the window of opportunity to intervene and course-correct the economy was missed. As the problems escalated to a critical point, substantial reforms could not be made in time. While the opportunity has already been lost in this case, the key lesson learned is that prompt action and reform is essential when facing major economic challenges. The government's inability to effectively respond to the significant economic pressures, due to political and institutional limitations, resulted in a failure to mitigate the negative impacts on the country's productivity and growth.

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

The EPRDF government, through the continuation of its "Revolutionary Democracy" policy (1991-2018), has created a policy framework that allows the financial sector to move towards liberation (Teshome, 2009). In many ways, the government has been introducing reforms to the financial system, showing a trend of reducing pressure and making various economic and financial sector improvements, thus starting the foundation of its power (Ayele, 2011). The financial liberalization measures taken at the time were based on the four identifiers mentioned above, and the reform approach was implemented gradually rather than all at once.

The primary goal of the reform was to transition from a system of government-controlled interest rates to one where market forces would determine deposit and lending rates. Prior to the reform, the government had maintained strict control over both deposit and lending interest rates. This government intervention had resulted in deposit rates being set artificially low, often below the prevailing inflation rate. This discouraged savings and limited the ability of the financial sector to effectively channel funds from savers to borrowers.

The 1992 reform sought to address this by liberalizing the interest rate regime. Deposit rates were allowed to rise above the inflation rate, incentivizing greater savings mobilization. The government also eliminated the ceiling on lending rates, allowing banks to set their own rates based on market conditions. To further support this transition, in 1995 the government introduced a 3% deposit rate floor. This gave banks more flexibility to offer competitive deposit rates and attract a greater volume of savings. Additionally, the reform eliminated the practice of having different lending rate ceilings for the private and public sectors. This unified the lending rate structure and gave banks full autonomy in setting loan rates for all borrowers. The reform also changed the way the government's treasury bill rate was determined. Previously, this rate had been set below the inflation rate, but it was now allowed to exceed both the inflation rate and the deposit interest rate. This helped establish a more market-oriented yield curve. Alongside these interest rate liberalization measures, the government also worked to develop a treasury bill market where these government securities could be actively traded. This further strengthened the role of market mechanisms in determining financial asset prices. while the reforms aimed to shift interest rate determination from government control to market forces in order to address price-related pressures, the actual outcome was that real deposit and treasury bill rates ended up being negative. This suggests that the reform efforts were not entirely successful in establishing a truly market-oriented interest rate regime. The persistently low real interest rates meant the central bank was still constrained in implementing an effective monetary policy. The negative real returns on savings also discouraged financial deepening and mobilization of deposits. In essence, while the 1992 reforms represented a positive step towards liberalization, there were still challenges in fully transitioning to a market-based interest rate system. The continued government influence and distortions in the financial markets prevented the reforms from achieving their intended goals of enhancing efficiency and strengthening monetary policy transmission.

Regarding banking structure, following the implementation of the Economic Reform Program, two major proclamations were issued: the Monetary and Banking Proclamation (No. 83/1994) and the Licensing and Supervision of Banking Business Proclamation (No. 84/1994) (National Bank of Ethiopia, 1994a; National Bank of Ethiopia, 1994b). The first proclamation reinforced the central role and responsibilities of the National Bank of Ethiopia as the central banking authority (National Bank of Ethiopia, 1994a). The second proclamation granted the National Bank of Ethiopia full supervisory and regulatory powers over the country's financial institutions (National Bank of Ethiopia, 1994b).

In essence, these two proclamations were aimed at restructuring the banking sector as part of the broader economic reform agenda. The key objectives were:

1. Strengthening the central bank's role and capacity to conduct effective monetary policy and oversee the financial system (National Bank of Ethiopia, 1994a; National Bank of Ethiopia, 1994b).
2. Establishing a sound legal and regulatory framework for the licensing, operation, and supervision of banks and other financial intermediaries (National Bank of Ethiopia, 1994b).

This reform of the banking sector architecture was a crucial component of the overall economic reform program. It sought to transform the financial system from a government-dominated model to one that is more market-oriented, efficient, and stable - with the central bank playing a strategic role in maintaining financial sector soundness and supporting broader economic development goals (Alemayehu, 2006; Mulat, 1998). The promulgation of these new banking laws was intended to lay the foundation for a more robust, well-regulated, and responsive financial sector that could better mobilize resources and allocate credit to productive economic activities. In addition to issuing supplementary proclamations, the Agricultural and Industrial Bank (Proclamation No. 200/1994) as well as the Housing and Savings Bank (Proclamation No. 203/1994) were reorganized as new entities and renamed the Development Bank of Ethiopia and the Construction and Savings Bank of Ethiopia, respectively. Furthermore, by opening up the banking sector previously fully owned by the government to domestic private sector participation, a new approach was pioneered that allowed the emergence of new private banks entering the market. This was the first such initiative in the country's history, and in 1995 the first private bank, the Awash International Bank, was established and began operations. This policy of liberalizing the banking sector continued until the ruling party, the EPRDF, changed in 2018. By that time, the number of private banks had reached 16, and the total number of bank branches exceeded 4,000, making a significant contribution to improving public access and branch network coverage. The existing banking regulations did not allow foreign investors or domestic private investors to participate in the domestic financial market, restricting participation to the three state-owned banks that existed at the time . However, this law was modified to permit the establishment of private banks in Ethiopia. The minimum capital requirement for setting up a private bank was significantly increased over time, rising from 10 million birr in 1994 to 75 million birr in 1999 and then 500 million birr in 2012 (National Bank of

Ethiopia, 2021). While these higher capital requirements helped strengthen the private banks, they also limited the number of new entrants, as the higher bar made it more difficult for new players to enter the market (Wolday, 2017). Despite these restrictions, the banking sector grew from 18 total banks, with 3 state-owned and 15 private banks, and the number of state-owned banks was later reduced to 2 through a merger (Tewolde, 2022). The private banks were also required to increase their capital beyond the minimum thresholds, allowing them to operate more independently from state control.

Prior to the reforms, the central bank had significant control over setting interest rates and directing credit to specific economic sectors and state-owned enterprises. This allowed the government to channel funding towards priority industries and state-owned firms, but limited the ability of banks to lend based on market forces and profitability. The reforms eliminated this centralized control, allowing banks to set their own interest rates, particularly in more profitable sectors of the economy. This incentivized private banks to focus more of their lending on private enterprises rather than state-owned firms, as they could earn higher returns in the private sector. However, the continued dominance of the state-owned Commercial Bank, which is a major player in the banking system, meant that overall credit to state-owned enterprises did not decrease substantially. The state-owned bank maintained significant lending to other state-owned firms as part of policy directives, offsetting the private banks' shift towards private sector lending. Despite this, the reforms did succeed in significantly increasing the share of credit flowing to private enterprises in recent years. This represented an important shift away from the historical pattern of state-directed credit allocation. The greater role of market forces and bank profitability in lending decisions was a key outcome of the reforms. Overall, the reforms represented a move towards a more market-oriented financial system, though the continued presence of large state-owned banks limited the full extent of this transition. The changes did, however, catalyze a notable increase in private sector access to credit. This however does not mean that the government was fully out of control of the banking sector. In fact, the opposite is true. The government has maintained significant control over the banking sector through various policy measures:

1. Enacting a law that requires government organizations to deposit their money only in government-owned banks. This directs the credit demand of these government entities exclusively towards the state-owned banks.
2. Requiring private banks to participate in major national development projects, such as the Grand Ethiopian Renaissance Dam. This compels private banks to lend to these government-backed initiatives.

3. Mandating that private banks purchase 27% of the bonds they lend out. This is equivalent to indirectly lending to government projects, as the private banks are effectively channeling a portion of their lending towards these government-backed endeavors.

As a result of these policies, the overall share of loans going to government organizations and state-backed projects has increased significantly. Even though this may not be direct government lending, the regulatory framework has given the government substantial control over the allocation of credit in the banking sector. In summary, the passage is indicating that despite not being a completely state-controlled banking system, the Ethiopian government has maintained a high degree of influence and direction over the lending activities of both state-owned and private banks through these targeted policy interventions. This allows the government to retain a central role in driving economic development through the banking sector.

The foreign exchange control system in Ethiopia has been in place since the Derg regime, when the government tightly regulated the allocation and use of foreign currency. After the transition to a market-based economy in the 1990s, the government has maintained a significant degree of control over the foreign exchange market (Dereje, 2021). One key aspect of the current system is the establishment of a foreign exchange sales and purchase market, operated by commercial banks (NBE, 2022). The National Bank of Ethiopia sets limits on the amount of foreign currency that each bank can hold, and banks are required to trade any excess foreign exchange through this centralized market. This allows the government to monitor and control the flow of foreign currency. Additionally, the government links the Ethiopian birr to the US dollar and sets the exchange rate, rather than allowing it to float freely on the market. The government allows a band of up to 2% between the buying and selling rates, in order to provide some flexibility while still maintaining tight control (MOFEC, 2018). However, this system has faced challenges due to chronic shortages of foreign exchange in the economy. The demand for foreign currency, particularly for imports, has often outstripped the available supply, leading to a black market and unofficial trading outside of the government-regulated system (Alemayehu et al., 2020). This has undermined the effectiveness of the government's capital flow and exchange rate management efforts. In summary, the foreign exchange control system in Ethiopia reflects the government's desire to maintain a high degree of influence over the allocation and use of foreign currency, despite the transition to a more market-oriented economic model. But the system has struggled to fully address the underlying foreign exchange shortages in the economy.

The Ethiopian government has implemented a comprehensive set of policies and regulations to exert tight control over the foreign currency system within the country. This suggests the government sought to restrict the accumulation and use of foreign currency reserves by private individuals and entities outside of the formal banking sector. One key measure is that the government requires all foreign borrowing by domestic entities to be vetted and approved by the National Bank of Ethiopia (NBE), the central banking authority. This allows the government to regulate the inflow of foreign capital and ensure it aligns with its macroeconomic objectives. Additionally, individuals and entities wishing to hold foreign currency accounts were subject to detailed regulations. This points to the government imposing strict controls on the ability of Ethiopian citizens and businesses to hold and manage foreign currency holdings, likely as a means of monitoring and limiting access to the country's scarce foreign exchange reserves. In fact, Ethiopians were largely prohibited from opening foreign currency accounts, and even banks faced restrictions on accessing foreign loans. This suggests the government severely limited the participation of both individuals and financial institutions in the foreign currency market, in order to conserve the country's foreign exchange reserves. Moreover, the system was structured such that import businesses could only access foreign currency through the formal banking sector. However, due to chronic shortages in the official system, an alternate informal market emerged where importers could obtain the foreign exchange needed for their operations. This indicates the government channeled access to foreign currency through the banks, but shortages compelled importers to seek out parallel, unregulated markets. Finally, the types of foreign currency that banks can hold and transact in are also closely specified through directives. This implies the government tightly regulated the foreign currency holdings and transactions of domestic banks, likely to maintain control over the supply and use of foreign exchange in the economy. The policy was part of a broader set of foreign exchange control measures implemented by the government to address chronic foreign currency shortages in the economy (Admasu, 2019). In addition to the bank surrender requirements, the government also regulated the allocation of foreign exchange, prioritizing it for essential imports and government-led development projects. One of the key motivations behind these controls was to channel more foreign currency resources towards the financing of the Grand Ethiopian Renaissance Dam (GERD) project through government bond sales (Admasu, 2019). The government viewed the GERD as a strategic national priority and sought to mobilize both domestic and external resources to fund its construction.

The macroeconomic environment during this period was indeed relatively favorable, with Ethiopia achieving high GDP growth rates averaging over 6.8% from the mid-2000s to the 2010s (World Bank, 2022). This strong economic performance allowed the banking sector to continue expanding, despite the constraints on foreign currency access (Gebreselassie, 2018). However, there were also concerns that the foreign exchange controls, including the bank surrender requirements, created inefficiencies and distortions in the economy over time

(Gebreselassie, 2018). For example, the controls may have led to the undervaluation of the birr, the local currency, and the emergence of a parallel foreign exchange market. Additionally, the foreign exchange constraints faced by the private sector, including importers and exporters, may have undermined their competitiveness and ability to invest and grow (Gebreselassie, 2018). This could have had broader implications for the country's long-term economic diversification and structural transformation. Despite these concerns, the government maintained a firm grip on foreign exchange management, viewing it as a necessary measure to support its development priorities and national security interests during this period of rapid economic growth and geopolitical tensions (Admasu, 2019). In addition, foreign exchange rate management and other reforms have led to an improved trade balance relative to domestic production. However, the growth in imports has been disproportionately large, resulting in a persistent trade deficit for the country. Nevertheless, policy measures that have been taken to transition the economy away from the constrained economy and high financial pressures of the Derg period have, based on empirical studies as well as practical experience in our country, generated better outcomes for the economy and the banking sector.

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 a emphasis on licensing banks that specialize in specific economic sectors (Dejene & Seher, 2020). 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. During this period also the implementation of key reforms—interest-based monetary mechanisms and a floating exchange rate—indicates a broader trend of financial liberalization in Ethiopia. These changes signal a departure from past practices that prioritized state control over market dynamics. The ability of financial institutions to operate with greater autonomy and the introduction of market-driven mechanisms reflect an evolving economic philosophy that embraces competition and efficiency. Moreover, these reforms align with global standards, making Ethiopia more attractive to foreign investors and enhancing its integration into the international financial system. As the country continues to navigate its path toward greater economic freedom, the successful implementation of interest-based mechanisms and a floating exchange rate will be critical for fostering a resilient and dynamic financial sector.

SUMMARY AND CONCLUSION

The Ethiopian financial system has undergone a complex historical evolution, shaped by a wide range of economic reforms and policy initiatives over time, leading to its current state. A key focus has been the expansion of the banking sector, which is now fully owned by the government and encompasses both state-owned and private banks, with the aim of bolstering the overall performance of the banking industry. However, the financial system still falls short of the desired level of freedom and autonomy in many respects. Moving forward, it will be crucial to guide the system's progression towards global standards through the careful implementation of new reform and strengthening policies. This should involve particular consideration of approaches that can effectively mitigate both temporary and lasting policy pressures on the financial sector, in order to reinforce its independence and self-governance. Extensive research has demonstrated the intricate relationship between financial freedom and economic growth, with these factors exerting a significant influence on the economic trajectories of many nations. Conversely, countries that have grappled with financial constraints continue to be plagued by persistent poverty and lagging economic progress. Given that the systems implemented in our own country have further entrenched this reality, it would be prudent to draw lessons from historical precedents and consider an approach grounded in sound economic principles to alleviate the current pressures facing the financial sector.

Particularly concerning is the persistent challenge of hyperinflation, which has been compounded by savings and credit mechanisms being trapped below zero for prolonged periods. This situation has deprived the economy of meaningful financial significance, making it exceedingly difficult to establish a framework capable of effectively regulating the economy through interest rate adjustments. This is particularly problematic, as it not only reduces the amount of deposits that can be mobilized, but also compels the economy to function based on "nominal" prices. This pricing mechanism becomes especially meaningless during periods of high inflation.

On the other hand, while it has taken considerable time for banks to freely set interest rates and determine the economic sectors suitable for lending based on market principles, the current government has provided policy support since the reform era. However, there are instances of interventions that undermine this freedom, present in both the previous and current systems. For example, the bond purchase mechanism tied to the loan volume issued by banks was a practice of the previous regime to divert the assets collected by banks towards the government. Despite the reforms, the persistence of modified interventionist approaches continues to undermine, albeit to a degree, the freedom granted to this market. While coercive global and domestic developments may have motivated the current policy framework, the pressures exerted on banks should not be overlooked. Valuable insights can be gleaned from examining the previous bond purchase policy and the practice of directing credit allocation.

Though not directly antithetical to managing the financial sector based on market principles, these interventions will incur economic costs by redirecting resources that could otherwise have been channeled towards the private sector and other productive areas of the economy.

Bank reserve requirements have historically been kept relatively low, particularly since the 1992 reforms that set a modest 5% reserve ratio. This policy has encouraged banks to expand their lending capacity to customers, while also increasing the productivity of banks' asset portfolios, as the majority of their assets generate revenue.

The current shift towards higher reserve requirements aims to address existing problems, mainly the issue of high inflation. However, there is widespread acknowledgment that this approach may lack long-term sustainability. The other notable historical footprint in the banking sector's development has been the long journey towards greater financial freedom. This demonstrates how a few key principles grounded in financial liberalization can shape the fortunes of the economy and the financial sector. Particularly, since the time when the private sector was enabled to participate in the financial market, which had previously been dominated by a few state-owned banks, the market has been diversified by the addition of alternative banks, allowing customers more options to support their growth. The bank to population ratio has not only strengthened, but has also led to the creation of a more accessible and improved financial system, with a greater diversity of banking services available to customers. This demonstrates that the involvement of the private sector, when afforded more opportunities in economic sectors, is capable of strengthening commercial activities. Even now, to further reinforce this progress, it would be appropriate to see privately-owned shares in government-owned banks, as observed in the telecommunications market, and a gradual integration of foreign banks into the market through the adaptation of their systems. The current system has positively reinforced the promotion of diversity through the introduction of interest-free banking, the growth of microfinance institutions into the banking sector, and the establishment of private housing banks. These approaches, which enable banks to operate with strengthened capital, are commendable and should continue.

Furthermore, the approach of supporting banks that operate with distinct market objectives is beneficial and should be encouraged.

The evolution of the finance sector has demonstrated that the changes made to its structure have led to an expansion in the number of banks as well as greater diversification of bank types operating within the sector. Although the banking market continues to be dominated by government-owned institutions, there are indications that a more balanced market distribution may emerge in the future. Notably, the rapid growth in the number of bank branches, which has now exceeded 6,000 for a population of 100 million, has played a substantial role in enhancing the accessibility and integration of banking services. The finance sector has witnessed a notable expansion in accessibility, marked by the growth of microfinance institutions within the country. This serves as a primary indicator of the sector's evolving landscape. Concurrently, the process of strengthening the capital capacity of banks has persisted, with efforts directed at enabling them to not only withstand vulnerabilities but also to invest in their capital. This, in turn, has empowered banks to explore new operations and technologies. Furthermore, a significant shift has occurred through the restructuring of government-owned banks to operate based on market principles. This new system has introduced an opportunity for wider participation in the market, moving away from the previous exclusive reliance on government-owned entities. This transition has opened the door for a more diverse range of players to engage in the financial ecosystem.

The reestablishment of Ethiopia's stock and capital market, which had been disrupted for an extended period, indicates that favorable regulations and preparations are underway to expand the financial market. Particularly with respect to the enhancement of domestic capital movements, there are promising signs for the future. The adjustments to the foreign exchange rate have largely followed historical trends, but remain driven by policy decisions rather than market forces. From the perspective of scarcity, policy pressures are evident to some degree, as banks are directed to trade in the permitted foreign exchange types and allocate foreign exchange across different economic sectors, rather than based on their own discretion. Additionally, an unconventional approach has emerged, where banks are required to contribute their foreign exchange holdings as government revenue. In addition, certain adjustments such as foreign exchange loans, foreign exchange deposit accounts, and particularly the government's withholding of foreign exchange from the diaspora, indicate that reform efforts are ongoing. However, the observed policy liberalizations on inbound capital appear relatively limited compared to the degree of control maintained over outbound foreign exchange, which is likely to constrain capital mobility. It may not be a bad idea to consider reforms that have been implemented and supported by research in some African countries like Uganda and Rwanda. The government's efforts to revitalize the bond market through the issuance of government bonds are intended to establish it as a source of capital and a conduit to the stock market in the future. However, the interest rate paid on these bonds, when considered in relation to the prevailing inflation rate and the yields offered to depositors, is relatively low. This has led many analysts to suggest that the government's actions amount to an indirect form of taxation. While this may not necessarily undermine the government's ability to repay its debts, given the high inflation environment, it is crucial that the pricing of these bonds adheres to market principles. Particularly, given the limited number of participants in this market and the lack of broader public engagement, the market is unlikely to expand or allow for price discovery through market forces, unless significant improvements are implemented. The measures taken to alleviate the pressure on the financial sector are encouraging, but it is clear that there are policy directions that need to be gradually examined further. Specifically, the economic reforms implemented after the Derg regime change have been progressing well, leading to good macroeconomic growth and structural outcomes. The current government's efforts to build on this positive track record and further strengthen the sector are commendable.

However, following the distortions that have emerged in the macroeconomy, the policy measures taken will need close monitoring. These include increasing monetary aggregates, managing the foreign exchange market and directing a portion to government revenue, matching interest rates with inflation, addressing price inflation in central bank loans, controlling treasury bill prices, and requiring mandatory government bond purchases from the banking sector. Carefully monitoring the impacts of these policies will be a priority going forward, in order to bring the microeconomy back to proper market functioning.

Overall, the steps taken to support the financial sector are a positive development, but ongoing evaluation and adjustment of policy will be crucial to address the emerging microeconomic challenges and ensure the sector's sustainable growth. From history and studies, it is understood that the opportunity for financial policy measures to achieve better outcomes is greatest when implemented on a good economic structure. Therefore, the inflationary pressures, trade imbalances, debt burdens, wars, and displacements that have tested the current period, in addition to seeking lasting improvements, are not only about ensuring peace, but also require wide-ranging reforms. Furthermore, the work that has begun to establish markets that can support the financial sector, such as the stock market and capital markets, provides an opportunity to facilitate the journey towards financial freedom by working in unison across the three market types (domestic, foreign, and stock markets). As the country continues to navigate its path toward greater economic freedom, the successful implementation of interest-based mechanisms and a floating exchange rate will be critical for fostering a resilient and dynamic financial sector.

NEXT PHASE OF LIBERALIZATION

Following the implementation of interest-based mechanisms and a floating exchange rate system, the next phase of liberalization for Ethiopia should focus on deepening market integration and enhancing the overall financial ecosystem. This phase will involve several key initiatives, including the establishment of a more competitive banking framework that encourages innovation and customer-centric services. Policymakers should prioritize the diversification of financial products and services, including the expansion of microfinance, insurance, and investment options, to meet the diverse needs of the population. In Ethiopia, embracing digitalization can play a crucial role in advancing financial inclusion and modernizing the banking system. The integration of digital technologies, such as mobile banking, online payment platforms, and fintech solutions, can provide underserved populations with access to financial services, even in remote areas where traditional banking infrastructure is lacking.

Additionally, strengthening regulatory frameworks will be crucial to ensure the stability and integrity of financial institutions, fostering trust among investors and consumers. Efforts should also be made to enhance digital banking and fintech solutions, which can improve access to financial services, especially in underserved regions. Encouraging foreign direct investment by creating a favorable regulatory environment will attract international players and bring in capital, expertise, and best practices. Furthermore, enhancing financial literacy programs will empower citizens to engage more effectively with the financial system, promoting savings and investment. Ongoing monitoring and evaluation mechanisms should be established to assess the impact of these liberalization efforts, ensuring that adjustments can be made as needed to address emerging challenges.

WAY FORWARD: SCOPE FOR FURTHER STUDIES

The way forward for Ethiopia's financial sector involves further research to inform policy and enhance digitalization efforts. Studies should focus on the impact of digital financial services on financial inclusion, drawing insights from comparative analyses with similar economies. Additionally, examining the regulatory implications of digital innovations will be crucial for fostering a balanced framework. Research on the effectiveness of financial literacy programs can guide better implementation strategies. Finally, longitudinal studies will help assess the long-term effects of reforms, ensuring that policies are data-driven and responsive to emerging trends.

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