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ETHIOPIA TOWARDS LIBERAL ORIENTED ECONOMIC REFORMS: IMPLICATION ON DEVELOPMENT OF FINANCIAL SECTOR

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Abstract
Ethiopia under the last two heads of the government is pursuing liberal oriented economic reforms. The major purpose of the article is to examine the impact of these economic reforms on the financial sector in Ethiopia. For this purpose the researchers used various proxy variables such as profit, market concentration, saving mobilization, credit to commercial sector and intermediation margin to measure the performance of banks. Premium density and volume is used to measure the reaction of insurance companies to study their reaction. The study found that financial liberalization has a positive but insignificant impact on the growth of financial institutions in Ethiopia. All the proxy variables used to measure the performance of banks and insurance companies in particular and financial sector in general show an increment in the post liberalization era. However, this change is not significant against expectation and pre reform period results.

Key Words: Economic Reform, Liberalism, Performance, Proxy Variables, Financial Liberalization and Financial institutions.

Introduction

A common view is that liberal oriented economic reforms have a potential to hold-back impediment in the financial sector that were present in large extent during interventionary periods. Theoretically it is well articulated that economic reforms encourage efficient functioning of financial institutions through introducing privatization and opening up of the market for competition. However, empirical findings about the relationship between liberal economic reforms and performance and ultimate development of the financial sector are diverse and sometimes yield conflicting results.

For instance Isik and Hassan (2003), Botric and Slijepcevic (2008) and Ahmed and Ansari (1998) in their cross country empirical work argue collectively about the possibility of enhancing the development of financial institutions by taking steps in economic liberalizations. Wheelock and Wilson (1999) and Ghosh (2016), however, find that deregulation has a negative effect on the performance of banks. The positive relationship between liberalization and development of financial institutions cannot be generalized across the board/nations. The existence of contradiction, co-uncertainties and variations in the empirical findings about the relationship between economic liberalization and financial institutions pose the question of causality. This developed interest to investigate the case in Ethiopian, the country that pursues liberalization in its economic undertakings more in recent times.

Ethiopia began to eliminate regulatory policies present in the economy and started to liberalize it earlier or following the 1991 unlawful government transition. This reform agenda have resulted in a widening and deepening of the financial system both in terms of volume, number and nature. However, 2017 and the years that follow were different. From 2017 and onwards the government implemented and promised to implement several liberal oriented economic reforms. The country is currently on an ongoing transition from developmental state oriented political and economic environment which presupposes central planning to liberally oriented market economies that contradicts central planning by new staffs of EPRDF politicians.

The importance of implementing liberalization policies should not be disregarded and testing the impact of these policy measures on the financial industry is an important academic concern. Moreover, it is wrong to regard liberalism and liberal oriented economic reforms as a single monolithic form of economic arrangement that have a similar outcome for countries that tried to implement it (Panic, 2007). Theoretical, empirical and professional literatures do not provide an unequivocal same answer to the single question “what is the impact of liberal oriented economic reforms on the development of financial sector in Ethiopia”. Nonetheless it must be noted at the outset that the period of reform in Ethiopia is not long enough to reflect the full impact of the reforms that have been implemented. Hence, this article should be taken essentially as tentative and indicative rather than definitive.

Survey of Conceptual and Empirical Issues

In this part the researchers tried to chart out empirical and theoretical foundations of the article. It aimed to specify the implications of the liberal oriented economic reforms on financial sectors.

Liberalization Trends

Neo-liberalism supported by Breton Woods’s institutions such as World Bank, International Monetary Fund and World Trade Organizations has gathered momentum as a single blueprint for the development of the financial sectors and prosperity of the global economy. With the powerful promotion by these organizations the world in the last half centuries was advanced through economic liberalization despite stops, gaps, and reversals. Expected benefits from an increased centralization of the economy and financial system and an excessive government regulations and restrictions did not materialize (Bertrand et al., 2007). Many countries introduced political and economic reforms which had great ramifications on their financial sector (Doumpos et al., 2015). The economy worldwide moved from government ownership toward greater private provision under fewer operational restrictions (Campos & Kinoshita, 2010). However, this happened in varying degree in developed and developing countries. The former is liberalized its economic structures ahead of the latter.

Developing countries under intense pressure from Breton Woods’s institutions and their arc advocates implement wide-ranging changes in order to conform to liberal economic model (Panic, 2007). These countries are liberalizing their financial systems mostly as part of the economic stabilization and structural adjustment programs. As a result of it many of them fostered their economic growth and efficiency; at the same time, many others got frustrating results by facing a financial crisis and halted economic growth (Kabir & Hoque, 2017).

According to Panic (2007) conflicting and inconsistent empirical evidences about liberal reforms are unable to its expose fundamental weaknesses. Countries are still hopeful about liberal economic policies. A small number of countries have shown since the early 1950s the extraordinary capacity of liberalism to achieve high material standards of living that have no historical precedents (Panic, 2007). However, chastened by the Great Depression governments of liberal countries are persuaded to implement reforms against liberalism. It is noticed that unregulated free market is a serious obstacle to improvements in economic welfare. In the absence of active stabilization policies, unregulated markets are highly unstable.

Nexus between Economic Liberalization and Financial Sector Performance

Financial sector is an integral part of the economy that majority of economic reforms fundamentally either directed towards or largely impacted them. Economy and politics influence other sectors throughout the world, however, the financial sector is the one and major that could be impacted more. Liberalization of the economy according to Arun and Turner (2002) ease restrictions and introduce

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private participation in the financial sector and stimulate growth in the sector. It charts out the financial sector more productive, competitive, vibrant and efficient.

An increased competition due to policy reforms, nevertheless, can lead to unstable financial environment (Aijaz A. Shaikh, 2017). Liberal reforms could result unexpected catastrophes on the financial sectors. For instance, total factor productivity declined following deregulation in the Spanish banking system during 1980s (Kumbhakar and Sarkar, 2003), however, the reform was pursued to boom the banking system. Close to 40% of Thailand's loans become non-performing and Indonesia deeply mired in recession after the reforms (Stiglitz, 2000). Due to difference in micro and macro-economic fundamentals the impact of liberal economic reforms on the financial sector is not quite the same in all countries. Liberal reform programs have not been always very successful. It will not quite work in the way they were intended.

Ethiopia under the last two heads of the government is implemented/ing liberally oriented economic reforms of currency devaluation, deposit interest rate deregulation, softening of banking business licensing and supervision and contractionary monetary and fiscal policies, signed an African Free Trade Act and it is in the process to privatize parts of state owned enterprises. These reforms introduced by fresh, in fact they have been in EPRDF camp, EPRDF politicians will be an opportunity for the financial sector and it will be a curse also.

Cross-country evidence on the impact of economic liberalization on growth of financial institutions is not same because liberalization is largely depends on the policy and institutional framework of the particular country. The policies adopted for a particular economy may not be suitable for another economy, because of differences in the financial structure, institutional base and differences in international connection (Kabir & Hoque, 2017). A large and technically sophisticated literature has examined the consequences of financial sector liberalization, but all of them did not have a same conclusion.

Theoretical literatures have revealed economic liberalization as a significant determinant of financial sector growth. Two pattern relationships between them is stated throughout these literatures. The first is that the development of the financial sector creates demand for economic reforms that in turn leads financial development. The other pattern of relationship is that liberalization of the economy leads to the development financial sector through mobilization of savings (Ghosh, 2016). This raised the question of causality between these two economic liberalization and development of the financial sector.

King and Levine (1993) indicate that liberalization reforms foster financial development. However, Alemayehu, Tonny and Getnet (2017) argue that liberalizing the economic system may increase fragility of the financial sector. Demirguc-Kunt and Detragiache (1999) and Arestis (2016) found that banking crises are more common in countries that have liberalized. Carretta et al. (2015) argued that the 2008 global financial crisis was a result of economic liberalization. Considering the crucial role played by the government, it is now widely agreed that an inappropriate and inefficient regulatory mechanism due to economic reforms increases the likelihood of a financial crisis (Chowdhury, 2002).

Neoliberal economic policies currently in vogue are created exactly the same sort of problems for the countries that have adopted them. Neoliberal reforms could impose incalculable costs on individual countries. Deregulation leads to intensified banking competition that could erode interest and profit margins and hence banks engage in riskier activities. As a result, the quality of loans deteriorates, enhancing banks' risk of failure (Burzynska, 2009).

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Research Design and Methods

Approach of the Study

In this study the researchers used a mixed approach of research. Though the quantitative approach, in this study, is justifiable and appropriate, the qualitative approach also very useful. The quantitative research approach used is based on the secondary data gathered from the National Bank of Ethiopia in years from 2014/15 to 2019/20 about proxy variables, described below, that show the development or not of financial institutions. Moreover, this study used an approach recommended by Salas and Saurina (2003). According to them the effect of deregulation, liberalization, is assessed either by examining the behavior of financial institutions performance during and after periods of deregulation in that the former taken as a base line for the analysis.

Sampling Procedure

This study used a three stage sampling procedure. Ethiopia, the first stage sampling unit, become a point of investigation since for the last four years it has been undertaking a number of liberal oriented economic reform measures to integrate with the rest of the world and achieve faster economic growth. The second sampling unit in this study is financial institutions. This article focuses on the financial institutions due the great share of the financial sector to the national GDP, the very nature of disproportionate effect of liberal oriented economic reforms on the financial sectors and the sector's very rapidly growth in the country.

The last stage in the sampling procedure is "what are the elements of the financial institutions the researchers are talking about?" The study included in part the financial institution[1] as defined by Fohlin (2016) or sampled all except micro finance institutions. The researchers used census sampling technique as far as banking and insurance institutions are concerned. Accordingly all private and public commercial banks (17 in sums) and insurance companies (17 in sums) are part of the study.

Proxies for the Development of Financial Sector

The effects of liberal economic reforms on the development of financial institutions are not readily observable, and hence, it is necessary to rely on a number of proxies of financial development. This article concentrated on the following proxy variables: volume of market concentration (Con), profitability (Prof), saving mobilizations (Savm), credit to commercial sector given (Cred), credit deposit ratio (Crdp), intermediation margins (spread between deposits and lending rates) (Intrm), premium/insurance concentration (Prcn) and premium/insurance density (Prdn). The first six used to measure the performances of the banks during the reform period and the last two were used to know the impact of the reform on the insurance companies.

Analysis Techniques

To carry out the analysis of this study the researchers used a three stage statistical model as stated in the following:

1. The development of the financial institutions is the sum of the development of parts it. This can be written in the form of equation as follows:
   $PFIt=\alpha+\beta PBt+\delta PIt+\varepsilon t$ ………………………………. (1)

[1] Financial institution consists of a set of banking and microfinance institutions that gathers excess cash or funds from savers and allocates financial capital to entrepreneurs, industry, and others in need of credit and insurance companies (Fohlin, 2016).

Where α is a constant financial development, β and δ coefficients, PBt is bank performance at a time "t", PIt is insurance performance at a time "t" and an εt error term.

2. PB_t the performance of banks at time "t" are written as a function or dependent on liberal oriented economic reforms, LERef and an error term μ; the effect of LERef on the development of the bank can be proxied through market concentration (Con), profitability (Prof), saving mobilizations (Savm), credit to commercial sector given (Cred), credit deposit ratio (Crdp) and intermediation margins (spread between deposits and lending rates) (Intrm) and the error term u.
   $PB_{it}=\alpha_0+ \alpha_1 LEPRef_t+\mu_{it}$ ………………………………… (2)
   $PB_{it} = \alpha_0 + \alpha_1 Con_{it} + \alpha_2 Prof_{it} + \alpha_3 Savm_{it} + \alpha_4 Cred_{it} + \alpha_5 Crdp_{it} + \alpha_6 Intrm_{it} + \mu_{it}$ ….. (2.1)
3. The effect of LERef on the development of insurance companies can be measured through premium/insurance concentration (premium as percentage of GDP) (Prcn) and premium/insurance density (premium per capita) (Prdn).
   $PI_{it}=\alpha_0+ \alpha_1 LEPRef_t+\mu_{it}$ ……………………………….... (3)
   $PI_{it} = \alpha_0 + \alpha_1 Prcn + \alpha_2 Prdn + \mu_{it}$ …………………………… (3.1)

To find the empirical relationship between economic liberalization and development of financial institutions in Ethiopia during the post liberalized period the times series approach or time varying variables were used. The researchers compute simple correlation coefficient to determine the statistical strength and direction of proxy variables. Therefore, this study adopted descriptive statistical analysis and coefficient interpretation and comparison.

Discussion of Results

Ethiopia had gradually experienced a series of economic reform measures that can be better presented in terms of generations. Ethiopia's economic system was a completely regulated regime till 1991. Policies were introduced to reduce the high extent of government participation in the economy after 1991. These reforms were aimed to prove the institutional framework and more competent functioning of banks and financial markets. In politico-economic terms, the move was from a Soviet-type model towards a more market-oriented Western strategy after the coming of EPRDF/first generation of reforms. This year was important for financial development because the government implemented several policies to ease private sector participation in the economy.

The strong inward-oriented and comparatively liberal development strategy of the post 1991 was moderated after the coming of Haile Mariam Dessalegn to the country's highest position through EPRDF's internal succession following the death of Prime Minister Meles Zenawi. This can be noted as a period during which second generation of reforms have been started. It was during this time that Ethiopia devaluated it's currency and a directive that deregulate deposit interest rate was set up. This was an encouraging scenario for the mobilization of money towards banks.

A more liberal oriented economic reform happen after the current prime minister assumes the government position/third generation of reforms. This prime minister begins with political reforms such as releasing of political prisoners, permitting guerrilla movements to enter the country for democratic struggles and amendment of some derogatory legislation. These are political reforms, of course, but have a tremendous repercussion on the growth of the financial sector. Continue with the reforms program the National Bank of Ethiopia implemented a set of directives to further promote banking business in the country. These include directives that permit the foreign nationals of Ethiopian origin to participate in the banking investment and directive that license and authorize interest free banking business. These directives are expected to bring more foreign capital and technical know-how, modern banking skills, and, widen and deepen the national financial structure and facilitated the establishment of private banks affiliated with Islam religion that oriented based on the Islamic way of doing business.

Major Elements of Post 2017 Economic Reform in Ethiopia

Liberalization consists of a large number of reforms and measures aimed at achieving a more rapid economic growth. Reform policy in Ethiopia contains most of the components of reform programs of countries that have aimed developing a market economy open to competition. These reforms contain three major strands: institutional reforms, including the restructuring of the National Bank of Ethiopia/setting up of a separate unit for bank and insurance supervision, legislative reforms/different directive come into force, and the liberalization of controls on financial markets, which mainly entails interest rate deregulation, licensing deregulations and currency devaluations. These reforms concerns and affects the financial sector.

Macroeconomic policies such as policies to improve the fiscal position with an effort of curtailing spending of the country were enacted. The government undertook wide ranging economic reform measures as part of the stabilization and structural adjustment programs. The liberalization process initiated can be considered as the major economic policy change. Such reforms are critical for the outcome of the financial sector. During the last four years, Ethiopia has passed through phenomenal economic changes and reforms. The agenda of the economic reforms over the last four years has included the following among others.

Exchange Rate Reforms

Exchange rate reform in Ethiopia began in October 1992 with devaluation the local currency around 140% (Rehman, et al. 2012). Gradually, however, the government replaced the foreign exchange allocation system from that determined administratively to the one determined by auction beginning May 1, 1993 (Admasu and Asayehgn 2014). As a consequence, the value of ETB progressively declined. The gradual devaluation policy followed by the government did not prove to be useful.

Ethiopia continues to experience widening current account deficits and rapidly declining foreign exchange reserves. The level of the reserve has reached a precariously low level, equivalent to 2 to 3 weeks of imports (Admasu and Asayehgn 2014). The government following a managed floating exchange rate policy three years ago the National Bank of Ethiopia (NBE) has announced a devaluation of the country's currency effective Wednesday, October 11, 2017. The Birr was devalued again leading to 15% depreciation in its value. The measure is seen by economic players as helping to boost the growth of the country's export sector which has experienced a sluggish outlook. It is also expected to reduce foreign exchange shortages and to ease debt burden.

Interest Rate Deregulations

Banks are financial intermediaries that channel funds from surplus economic units to deficit units to facilitate trade and capital formation (Soyibo and Adekanye, 1992b). For the financial system to be efficient, it must pay depositors favorable rates of interests and should charge borrowers favorable rates of interest on loans (Chirwa 1999). Therefore, interest rate deregulation is at the heart of financial sector growth.

Interest rate affects financial sector development through its influence on volume of financial savings and on the cost of capital (McKinnon, 1973; Shaw, 1973; Fry, 1988; Leite and Sundararajan, 1990). National savings rate may be affected positively by the real deposit rate of interest. In countries where the deposit rate is negative it can be increased by raising the real deposit interest rate. In Ethiopia the

NBE ended setting the maximum deposit rate and replaced a minimum deposit rate (5%). The minimum interest rates on deposits have been pushed up by 2%; it will now stand at 7%. The central bank said it raised the main interest rate to stimulate savings as well as to counter inflation.

Other Miscellaneous Reforms

In addition to the above measures there has been an emphasis in the government budget-making to restricting budget deficits through fiscal reforms. Program of disinvestment of public ownership in public sector corporations has been launched. State-owned enterprises, including untouchables such as Ethiopian Airline and Ethio telecom, are in the process of being privatized. A privatization commission has been set up to make recommendations on the phasing of the disinvestments. In 2017 and onwards a package of financial sector reforms was announced that relaxed the licensing procedure. Moreover, control over public expenditure was tightened; a tax reform was launched with the objective of broadening the tax base. The reforms have provoked significant consolidation of the financial sector.

Effects of the Liberal Oriented Economic Reforms in Ethiopia

National Bank of Ethiopia and government started to liberalize the system through the adoption of free entry policy for banks and other financial institutions. These played an important role to capital mobilizations and its efficient allocation. However, liberalization is the first step for the development of the financial sector but its result is unknown without evaluation.

Reaction of Banking Sector

It is anticipated and empirically verified that liberalization play an important role in promoting the volume of intermediation. These can be measured in terms of share of credit given by banks, financial deepening, spread between lending and deposit interest rate and credit-deposit ratio. The first two of capture the credit allocation and the others the deposit mobilization role (Kabir and Bin Houque 2007). If liberalization does not contribute either in terms of finance and credit availability, or the reduction of intermediation costs, or deposit mobilization then it can be said that liberalization has departed from its target (Kabir and Bin Houque 2007).

From its very inception Ethiopia's financial industry has made impressive growth and always strived for improvements. However, they have experienced more growth following the liberal oriented economic reforms compared to the pre neo liberal phase. All the important banking sector development indicators, such as market concentration, profitability, saving mobilization, credit to commercial sector, credit-deposit ratio and intermediation margins have increased tremendously since liberalization as indicated in the table below.

It is found a positive relationship between economic reforms and growth in the financial sector following economic liberalization in Ethiopia except intermediation margin. The economic sector reforms provide the necessary impetus for the growth of the sector. The relationship between the proxy variables taken and the economic liberalization found positive, except intermediation margin which shows the negative result. This implies that the coefficients of the bank performance proxy variables have been increased after liberalization. However, the effect of economic liberalization on the performance of banks is insignificant.

Bank Performance Proxy Variables						
	Market Concentration	Profitability	Saving Mobilization	Credit to Commercial Sector	Credit-Deposit Ratio	Intermediation Margin
Coefficients	16938.82	3.99e-06	12676.72	6896.45	.0208333	-.0041667
Standard Error	(25222.6)	(.0000194)	(20906.51)	(10226.96)	(.018359)	(.0396557)
R-squared	0.0057	0.0005	0.0047	0.0058	0.0162	0.0001

Bank performance measured through proxy variables
Source: Researchers own analysis

Moreover, the reforms are responsible for the mushrooming of sixteen new financial companies that applied for banking business license to commence their operations in years to come. These include banks such as Amhara, Jano, Ahadu, Geez, Selam, Afro, Zad, Geda, Ethio Diaspora, Shebelle, Kush, Ramis, Hijara, Goh, Sheger and Zeme Zem. The reform measures have resulted in a widening and deepening of the financial system both in terms of the volume and nature of financial business. This transition has had profound implications, favorably, for the financial system. New financial institutions have emerged and the role of the private sector in the financial system has been expanded. However, the country's transition was not a utopian where the public involvement never ceased to exist. The state-owned commercial banks account for significant amount of the banking sector assets.

The Reaction of Insurance Companies
The reforms in the financial sector did not spare insurance sector, rather they created major effects that led to remarkable improvements. The process of capital formation as a result of liberalization is encouraged the expansion of insurance services. Together with liberal reforms the growing Ethiopia's economy has printed a significant development effect during the post reform periods over the insurance companies. Table 4.8 gives a brief summary of the premium earned following the reform process and before the reforms by the insurance companies.

Due to the reforms there was a tremendous increase in competition that led to increase in the level of insurance penetration (premium as a percentage of gross domestic product [GDP]) and insurance density (premium per capita). As the table below presents the level of insurance penetration improved in a year following 2017. The premium income also increased. The insurance business expanded by an amount as compared with years ago in terms of premium earned. This performance of Insurance Corporations is an indication that the policy of liberalization has benefited the corporation which has achieved business growth in the subsequent years of the liberalization.

Year	Total Earned Premium	GDP at Constant Price	GDP at Current Price
2014	2,806,262	1,342,555,897.7	1,226,637,362.0
2015	3,965,351	1,449,397,450.6	1,449,397,451.0
2016	4,495,088	1,596,481,627.9	1,703,798,211.9
2017	5,437,340	1,719,491,326.2	2,064,789,244.0
2018	15,727,345	1,874,689,297.0	2,543,623,152.0

Insurance Corporations performance measured through proxy variables
Source: Researchers own analysis

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Conclusion

Governments throughout the world have introduced liberalization policies. Policy reforms in the economy have a direct impact on the growth of the financial sector. The balance sheet at the adoption of economic reforms in Ethiopia emerges from the analysis of this fact. The last two heads of the government in Ethiopia have introduced some additions of liberal economic reforms. They are emphasized to increase the role of market activities in the financial system. These reforms have put a tremendous impact on the growth of the financial sector.

The influence of policy changes has been reflected on the performance of insurance corporations and banks. Performance of a financial institution is insignificantly but positively influenced by the changes in economic policy. Measurement of financial sector growth through the proxy variables shows that overall financial development in Ethiopia went from minimally developed during the pre reform period to somewhat developed. Nonetheless, the economic liberalization proves unsatisfactory to attain its purpose because of the scale of the problems which the financial sector inherited from the pre-reform era, and especially because of the dominant market position of the public sector bank. Notwithstanding the general positive outlook alluded above, the financial sector in the country is still shallow and reserved for local investors who are thus protected from global competition and best practice in the industry. It is also dominated by the state owned CBE. It is now evident that there is no 'one true path and success' through a market-economy.

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