Institutional Aspects of Reforming the Financial Sector: The Case of Regulating Banking in Post-Reform Ethiopia

(Alemayehu Geda)

1. Introduction

Following the 1974 popular revolution all privately owned financial institutions including three commercial banks, thirteen insurance companies and two non-bank financial intermediaries were nationalised on 1 January 1975. The nationalised banks were reorganised and one commercial bank (the Commercial Bank of Ethiopia), a National Bank (recreated in 1976), two specialised banks (the Agricultural and Industrial Bank – recently renamed as the Development Bank of Ethiopia and Housing and Savings Bank – recently renamed as the Construction and Business Bank) as well as one insurance company – Ethiopian Insurance company were formed.

After the change in government in 1991, and the new direction in economic policy (especially after 1992), these financial institutions are being reorganised to work in a market oriented policy framework. Besides, new privately owned financial institutions are also being allowed to work along with the publicly owned ones. The discussion about these financial institutions, in particular their regulation and supervision, being a major institutional issue, is the subject of the rest of this paper.

The intermediary role of financial institutions takes different forms in different economic systems. In Ethiopia, under 'State Socialism' (1974 to 1991), financial institutions were basically executing the economic plans outlined by the central planning organ. In such set-up regulation and supervision were not critical since the national plan was believed to regulate and direct the activities of the financial institutions. Moreover, financial institutions were directed to finance some public projects that may not pass proper financial/economic appraisal, the arguments simply based on either ideological grounds or on 'merit wants'. Such a system was running in Ethiopia until 1991, a year that witnessed the overthrow of the 'Socialist State'.

In terms of economic policy, 1991 witnessed a marked departure from the previous 'Socialist System'. The basic difference lies on openly adopting a market-oriented economic policy, which was actually initiated, even if not implemented, by the previous (*Derge*) regime.

In terms of the financial sector, this new change in policy required an enormous change in its activity. Not only it is going to serve the private sector, which hitherto had been demonised, but also new private financial institutions were emerging. Equally, the role of the Ethiopia's central bank (named National Bank of Ethiopia, NBE henceforth) needed to be reformulated again. Thus, financial sector reconstruction was the top item in the government's agenda.

In undertaking this task the Ethiopian government adopted a strategy of; (a) gradualism: in undertaking different economic financial liberalisation measures (the issues of sequencing and timing), and (b) strengthening domestic competitive and operational capacity before full liberalisation: restricting the sector to domestic investors only, strengthening the regulatory and supervisory capacity of the NBE, providing autonomy to banks etc. This latter issue, i.e.

institutional building, was taken as fundamental component of financial sector liberalisation. In line with this strategy various proclamations and regulations were passed since 1992.

In this study an attempt to understand these transitions will be made. In particular what is required of both the new financial institutions and the regulatory organ, the NBE, will be examined. In doing so the study will attempt to capture whether proper regulatory and supervisory capacity - institutional building - is in place when the role of the financial sector is in such a state of flux. Further, the Ethiopian strategy is very slow in the eyes of the IMF. Thus, this paper will also explore the implications of this strategy on the relationship between Ethiopia and international institutions such as the IMF.

The rest of the paper is organised as follows. In section 2 brief theoretical points about liberalisation and regulation of financial sectors will be made. Section 3 will be devoted to the analysis of the regulatory mechanisms in the financial sector. In sections 4 and 5 some economic liberalisation measures and Ethiopia's relation with the IMF are, only briefly, discussed. Section 6 concludes the paper.

2. Banking Regulation and Supervision: Some Theoretical Issues

Following the Mckinnon (1973) and Sahw's (1973) paradigm, financial liberalisation has been high on the agenda of developing countries. This paradigm, the financial repression school - as it is sometimes referred to - argues that government intervention in the sector (in particular through subsidised interest rate and (favoured) credit allocation) not only distorts the financial market but depresses savings (and hence accompanying investment) and leads to inefficient investment. The policy prescription that follows is liberalisation. This has been endorsed by international financial and development institutions (such as the World Bank and IMF) and was one component of the reform package that came with the name of Structural Adjustment Programs.

However, the outcomes of these liberalisation measures in different countries had been diverse. Many developing countries that went through this agonising reform process are unable to enjoy what was promised in this package in general and the financial sector's prosperity in particular.
Vos (1993) noted that the major factors that could explain the failure of financial liberalisation in Latin America and its success in Asian developing countries (such as Korea and Taiwan) lies in the control and intervention by state to address structural problems without disregarding market-oriented performance criteria. Thus, for Vos, gradualism (in timing and sequencing) and addressing some of the setbacks in the financial sector reform, such as lack of sensible prudential and supervisory capacity in place before the on set of the financial sector reform, are crucial. As for the latter issue, i.e. prudential regulation, its importance has been forcefully demonstrated by the experience of the transition economies of Eastern Europe, former Soviet Union and that of Asian countries such as China. The failure in Russia is partly attributed to the fact that reformers predicted institutions (such as regulatory and supervisory capacity) would follow privatisation rather than the other way round (Shleifer and Vishny, 1998 cited in Stiglitz, 1999). As Stiglitz (1999) noted "transferring assets to the private sector without regulatory safeguards has only succeeded in putting the 'grabbing hand' theory of government (i.e. The state is the problem) into the 'velvet glove' of privatisation" which is doing the same with much less restraint. On the other hand, the gradual or incremental approach in China, such as a closed capital account

(actually more an economic than a prudential issue), helped China to have quite a supportive financial sector (Qian (1999) cited in Stiglitz, 1999). According to Stiglitz (1999) the Chinese had the wisdom 'to know they did not what they were doing'.

One can then safely generalize that for poor reformers such as those in sub-Saharan Africa gradualism and institutional building is much more central. As noted by Qian (1999), "the main lesson from Chinese experience is that considerable growth is possible with sensible but not perfect institutions, and that some 'transitional institutions' can be more effective than the best practice institutions for a period of time because of the second-best principle: removing one distortion may be counter-productive in the presence of another distortion" (Qian (1999) cited in Stiglitz 1999). Thus, the foregoing discussion underscores the importance of financial sector/bank regulation. But, what does bank regulation mean?

Basically, bank regulation can be classified as *economic* and *prudential*. The former comprises restriction on interest rates, credit allocation and on financial market entry. These are also largely the subjects of financial liberalisation. Prudential regulation and supervision on the other hand, aims at ensuring the safety and soundness of financial institutions and hence at preventing financial crisis (in particular among commercial banks), by examining capital adequacy, asset quality, management, internal controls and audit, earnings and liquidity (Bascom, 1994:170; Polizatto, 1993: 173). According to Polizatto (1993), prudential regulation is the 'codification of public policy towards banks, while banking supervision is the government's means of ensuring the bank's compliance with public policy' (Polizatto, 1993: 174).

The issue of regulating and supervising the banking sector brings to the fore the issue of the role of state in the economy in general and the financial sector in particular. On the one hand we have the Stiglitz line of thought (1993, 1998) where market failure is believed to be rescued by government intervention. On the other hand, others such as White (1995), cited in Cole and Slade (1996), and international institutions such as IMF argue about the danger of government failure. Whichever argument is followed it is widely acknowledged that regulating banks is important owing to the following reasons noted by Giddy (1984), cited in Sheng (1993): to strengthen the efficacy of monetary policy (through banks' power to create money by credit creation); for credit allocation; to ensure competition and innovation; to maintain public confidence in the system.
According to the World Bank, bank supervisors in LDCs focus on compliance with monetary policy regulations, foreign exchange controls, and other economic policy regulations such as allocating credit. As a result they neglect the prudential aspect of financial monitoring such as assessing the quality of assets, accounting procedures and management control. This, according to the Bank, combined with macro instability and lack of adequate legal system, is the cause of bank insolvency (World Bank, 1989: 91). In the African context the latter can also be linked to the colonial legacy (See Polizatto, 1993). The colonial legacy (in particular the British) in Africa is that (a) banks are incorporated under provisions of a company act. This created a problem for supervisors since the power to quickly intervene in insolvent banks is lacking; (b) the legacy of reliance on real estate collateral which, in general, could lead to concentration of credit on small groups (Polizatto, 1993:185). The reliance on real estate collateral also enormously reduces potential borrowers with dynamic entreprenual motive and limited capital.

The development policy of developing countries requires higher levels of investment, which usually are risky. If the government uses banks (credit from banks) to realise such investments, the importance of prudential regulation and supervision will be more accentuated. In such an environment the goal of bank supervision is to promote safe, stable and efficient financial system (World Bank, 1989: 91). The World Bank (1989) noted the following as the main aspects in carrying out prudent financial regulation and supervision (World Bank, 1989: 91-94; see also Polizatto, 1993): Off-site supervision which is based on reports and inspections (but can not assess risk adequately); Strict licensing procedures and capital adequacy measurements (capital-risk weighted assets ratio); Asset classification and provisioning (appropriate provisions for loan losses, write-offs, and suspension of interest income); Liquidity and portfolio concentration (liquidity and accumulation of short term interest risks usually due to maturity mismatches, and risks from concentration of credit, respectively); Enforcement power and Auditing (issues like the power of supervisors to take certain measures, external auditing on certain standard guidelines, and political commitment to allocate resources to associated activities).

In addition to prudential regulation, there is the important aspect of the legal framework that affects banks. This is 'the body of commercial laws and regulations governing bank's contractual relationship with its customers'. A key aspect of this legislation is the one that relates to debt collection and recovery. For banks to be successful, the legal system must be able to balance the right of banks to foreclose on collateral with the right of individuals and firms so that, in the final analysis debts can be recovered in a timely manner (Polizatto, 1993: 183).

In general, as aptly remarked by Stiglitz (1998), 'the key issue should not be the liberalisation or deregulation but construction of the regulatory framework that ensure an effective financial sector' (Stiglitz, 1998: 16). Once this is attained, he noted, it is of paramount importance not to ignore the 'very sensitive issue of sequencing' as opposed to overnight deregulation (Stiglitz, 1998: 16). Finally, Stiglitz (1998) noted, in all countries the primary objective of regulation should be to ensure that all participants face the right incentive.

3. Regulating the New Financial Sector: NBE, and Public and Private Banks

In post-reform Ethiopia the financial sector is in the process of moving from a controlled economy, where the role of the financial sector is to ensure the realisation of the national (central) plan, towards a sector where its performance is largely guided by market forces. This undoubtedly requires the development of supervisory and regulatory capacity at the National Bank of Ethiopia (NBE). The NBE has established such a division in 1996 and also prepared quite a detailed manual for carrying out this responsibility (NBE, 1996). The rest of this section is written based on this manual and various regulations issued by NBE.

Regulating the new financial sector in Ethiopia takes two forms:

(1) Licensing and approval of external auditors, and

(2) Bank supervision, which in turn takes two forms

(a) Off-site Surveillance, and

(b) On-site Examination

1. Licensing and Approval of External Auditors

The NBE is guided by Proclamation No 84/94 in conducting this function. When request for licensing is made, the NBE will check whether the request is in line with the proclamation and starts evaluating the feasibility study before deciding on the matter. Similarly, NBE conducts renewal of licenses pursuant to the latest on-site examination and off-site surveillance (discussed below). Essentially the analysis needs to focus on liquidity ratio, capital adequacy and asset quality indicators. Request for branch expansion will also be accepted following examination of the feasibility study of its future operation.

Part of the regulatory activity of NBE is appointing appropriate auditors by examining these auditors' past experience (or record). On top of this, the NBE will examine other relevant variables such as security of the premises, staff operation area, insurance, documentation policy and procedure and the like.

2. Bank Supervision

The NBE's desire to maintain strong banking regulatory system is based on maintaining (NBE, 1986: 16): strong prudential and formal accounting standards, off-site surveillance techniques, full-scope on-site examination of all banks on a regular basis, and prompt examination actions. In the following sub-sections I will briefly discuss both off-site surveillance and On-site examination procedures employed by the NBE.

2.1 Off-site Surveillance

This technique aims at providing policy makers (in particular the governor and the board) the soundness of banks using key financial data on regular basis. It also aims at detecting emerging weaknesses and, thus, determines whether 'On-site Examination' is called for.

Each bank is required to submit such key financial data (balance sheet, income and expense, credit concentration, non-performing loans, risk weighted assets, reserve and liquidity report, annual branch network as well as other financial indicators) on a regular basis (at least monthly and quarterly). On the basis of this data the supervisory unit will compute different rates, as noted in Table 1 below, that indicate the performance of banks.

The 'Off-site Surveillance' basically focuses on performance analysis. The analysis comprises examination of level, trends and peer group comparison using the indicators listed in Table 1 and described in detail below.

2.1.1. Capital Adequacy

The objective of carrying this analysis is to take account of all possible risks of loss to which the commercial banks may be exposed. This may take a form of: (a) counterpart default arising from

on/off balance-sheet operations (credit risk); (b) operational risk (management negligence); (c) risks that may arise from the operation of subsidiaries.
At a concrete level these are inferred from: risk weighted assets (the weight as defined by NBE Directive No. SBB/9/1995); credit concentration (list of 10 largest borrowers, see SBB/8/95 2), and loans/credit to related parties (20 largest borrowers by NBE Directive No. SBB/11/1996; 17/96 amendment 3).The minimum capital requirement for commercial banks operating in Ethiopia is set at 8% of risk weighted assets.

2.1.2 Asset Quality

Evaluation of asset quality basically involves identifying non-performing assets. In particular assessing the quality of loans and advances is very important, as this item constitutes a good chunk of commercial bank assets. In carrying out this task the NBE's supervision division looks on whether there is adequate provisions for non-performing assets. This is arrived at by comparing the actual provision with the one legally required. The latter is given on NBE's directive SBB/7/95 where annual provisions for bad loans (loans which have no collateral) is 100% and for doubtful loans (over due more than one year and not adequately secured) is 50%.

2.1.3. Earning and Profitability

The supervision department is also required to examine the profitability of banks. This is done based on some key indicators. The most important ones being:(a) returns on assets which is computed as net income after tax divided by average total assets, (b) returns on equity that is computed as net income after tax divided by average equity capital, (c) measures of efficiency such as staff productivity, spread, non-interest income etc.

2.1.4 . Assessing Liquidity

Assessing liquidity has the objective of ensuring that each bank is capable of meeting the day-to-day cash deposit withdrawal needs of customers. In this regard, taking prudential mix of liquid assets is important in the operation of banks. NBE supervises this and such analysis needs to be carried more frequently since liquidity problems can easily lead to the collapse of banks.

According to NBE's Directive No. SBB/5/95, any licensed bank shall maintain liquid assets of not less than 15% of its total demand, saving and time deposits and similar liabilities with less than one month maturity period. At least 5% of the required liquid assets shall be in the form of primary reserves (notes and coins, and balances held with the NBE); and 10% of it in the form of secondary reserve assets (defined in Article 16(2)(b) of proclamation No.84/1994). Moreover, banks need to submit their weekly liquidity position to the NBE. These are NBE's legal bases to ensure the quality of assets held by banks.

2.1.5. Other Important Indicators

Deposit concentration, market share of the bank in question and overall solvency are other important indicators that can be used in off-site surveillance.

All the above indicators need to be prepared by all commercial banks and be submitted to the NBE. In order to help banks easily prepare such reports, the NBE has prepared and distributed a detailed manual. The problem is, however, that NBE's supervision division is yet in the process of building its capacity. Right now it is weak but seems to have the potential to be strong in the future.

2.2 On-site Examination

Based on article 20(a) of the 'Licensing and Banking Business Proclamation No 84/1994', the NBE has the responsibility of regulating the commercial banks using on-site examination. Thus, on top of the off-site surveillance described above, the NBE does physically go to banks and asses their organisation and operation, loan management procedures and the adequacy of control mechanisms that are in place. Such examination is crucial to determine, *iter alia*, whether rules and regulations are being properly followed. Moreover, it overcomes some of the shortcomings of off-site surveillance such as unreliable or misguided reports.

The 'On-site Examination' by the NBE is quite rigorous. The examiners are expected to compile more than 100 pages of information, the format of which is provided in the NBE's supervision and regulation manual. Such an examination is conducted under strict confidentiality. This 'On-site Examination' should be preceded by a 'pre-on-site examination plan' that comprises (i) overall planning, and (ii) specific planning. At the 'overall planning' level, the supervision department of the NBE draws a broad schedule of exams to be conducted in 12 months period. The examination should start from the most dominant banks (owing to their important impact on the national economy), and then to known problem banks and those not examined for long periods. Whatever the condition of banks, all banks need to be examined at least once in a year. Pending on the decision of the NBE supervision division, the on-site examination could be either; (a) full scale, where all main risks and operations of a bank are examined, or (b) limited scope and specialised examination that covers only certain areas of risk (e.g. asset quality) and specific area of bank operation (e.g. management information system). The examination could be an announced or a surprise one.

After the ‘overall planning’ is set out, examiners are required to draw ‘specific planning’. Here examiners are required to prepare additional steps necessary for the specific bank in question, and based on their initiative and judgement.

Generally, the examination should focus on a list of items that can generally be categorised under the following headings; (a) Overall management of the bank, (b) financial position of the bank, (c) soundness of operations, and (d) physical and other control systems. Once all the required preparations are made, the actual examination shall be carried in the following order: (1^{st}) Evaluation of board of directors; (2^{nd}) Evaluation of management, management information systems, and internal control systems; (3^{rd}) Analytical review of financial indicators; (4^{th}) Documentation and recording systems inspection; (5^{th}) Physical, computer and internal control systems inspection; (6^{th}) Inspection of whether proclamations and regulations are being properly followed up or not; (7^{th}) Inspection of foreign exchange regulation and whether NBE directive check list is being followed or not; and finally, (8^{th}) Verification of various returns (reports) to the NBE. After all this is done, final report of the ‘On-site Examination’ will be made available by the supervisory team to relevant NBE officials.

At this stage it is worth asking what the experience is with the ‘On-site Examination’ and ‘Off-site Surveillance’. NBE’s supervision division was established in 1996. In the last three years of its activities, the division has carried out ‘On-site Examination’ on all banks, although this was not as frequent as is specified in the manual. This is partly attributed to lack of skilled human resource and that the division started operation fairly recently. Be that as it may, one major problem in the activity of the supervision division is valuation of assets. The supervision division of the NBE is in the process of strengthening the ‘Off-site Surveillance’ section, which so far is weak. Thus, it relies on ‘On-site Examination’ conducted on prior notice basis . On ‘On-site Examination’ there could arise a difference of opinion or interpretation on the valuation of assets. Sometimes banks may say that they have a particular level of assets and the supervisors’ valuation of those assets may not coincide with the bank’s perception. This is one major problem. The other problem lies on the capacity building at the NBE. As a remedy however, the NBE, in collaboration with the IMF and other related institutions, is attempting to address the issue of human resource development through on-the-job training and facilitating the participation of NBE’s staff in different workshops.

In general, the new task of regulating and supervising the new financial institutions is not very much challenging to the supervision division. One of the main reasons for this is that there is no fundamental change in the operation of the major bank, the CBE. Moreover, both the newly structured public banks and the emerging private banks draw both their staff and functional structure from CBE. Since NBE’s staff is familiar with CBE’s ways of conducting businesses, the challenge is not as difficult as expected. Probably the division’s work will be challenging when new (foreign) banks start operations, to the activities of which the staff is not familiar.

In conclusion, it is imperative to note that strengthening this division is crucial not only because banking activity may get increasingly complex in the future but also because standardisation of supervision and regulation may come as one of the Breton Wood's institutions' conditionalities in the future. Hopefully, the new conditionalities will take note of the existing reality in developing countries.

4. Economic Liberalisation Measures: Other Instruments of Regulation

Hand in hand with the prudential regulation discussed above, there were also *economic* liberalisation attempts in the financial sector since 1992. This consisted of interest rate and foreign exchange liberalisation, and the introduction of Inter-bank foreign exchange and money markets.

With regards to interest rates, the previous regime was characterised by discriminatory interest rate and credit allocation policies. Currently however, the interest rate is fairly liberalised through a series of gradual steps since 1992. Now, the NBE has let go of all restrictions on interest rates and only sets a floor for deposit rates, leaving all others to be determined by market forces. The latest interest rate policy is given in Alemayehu (1999).

As to exchange rates, again the previous regime was characterised by an unwarrantedly appreciated, fixed exchange rate against the dollar. Thus, the new regime started by a massive devaluation to the tune of 140% against the former rate. Then on in 1993, the NBE introduced the Dutch Auction System for the allocation of foreign exchange. At first the auction was conducted on a fortnight basis and in due time, along with some gradual liberalisation efforts (such as the reduction in the bid cover requirement, abolition of negative import list and the ceiling on demand for foreign exchange etc.), the NBE began foreign exchange auctions weekly. Another recent development in this regard is the substitution by the NBE of a wholesale auction system in place of the former retail one (for a detailed exposition of the gradual achievements in foreign exchange rate liberalisation, see Alemayehu, 1999).

Finally, new developments in the financial sector, in terms of economic liberalisation and associated regulation are the 'Inter-bank foreign exchange' and the 'Inter-bank money' markets (Directives No. IBM/01/1998 and IBM/02/1998 respectively, and other related documents). The establishment of the former is primarily motivated by the recognition that the foreign exchange supply by the NBE through the auction system is not sufficient to satisfy the demand of banks. The 'Inter-bank foreign exchange market' (IBFEM) is an exclusive market for banks to trade foreign exchange with each other (NBE Directive No.IBM/01/1998). The 'Inter-bank money market' (IBMM) describes the borrowing and lending of funds between banks, micro financing institutions, and non-bank financial institutions at interest rates that are freely determined by the borrowers and lenders themselves (NBE Directive No. IBM 02/1998).To assess these two markets, banks are required to submit associated and timely reports on a regular basis to the NBE. Furthermore, the NBE has issued a code of conduct that has an extensive regulatory content on the two markets (see NBE code of conduct for IBMM).

5 Speed of Financial Sector Reform and Its Implications for Ethiopia's Relation with the IMF

The hallmark of the strategy in liberalising the financial sector in Ethiopia is gradualism. This approach is not without problems, however. International institutions, which sponsor and financially support the liberalisation scheme, especially the IMF, are not satisfied with the pace at which the process is being carried out. This, at times, has reached at a point where the IMF has temporarily suspended its support. The problem is, however, that the various policy framework papers jointly authored by the Ethiopian government and the staffs of the two Bretton Woods' institutions are quite comprehensive embracing almost all major policies, that it is difficult to relate any disagreement between Ethiopia and the IMF/WB solely to the financial sector (and to seek solutions henceforth).

Examination of such policy framework papers reveals that: (a) since the on-set of the structural adjustment program in Ethiopia, the performance is by and large in line with the target set in documents (even if there are occasional years where the performance is both above and below the target, the latter being highly correlated with bad weather conditions); (b) when we compare the time schedule set in the policy framework papers and the actual implementation of policies, the Ethiopian government is behind the schedule in many instances. However, it is interesting to note that this (at least in previous years) by and large had not led to disagreement between IMF and Ethiopia.

Then what is the problem for the IMF that led it suspended its help? An examination of the time schedule set in the policy matrix of various policy framework papers and the performance of Ethiopia reveals that if this is the sole cause of disagreement, the IMF should have suspended the program long ago. This obviously points to possibility of having other explanations that may lurk behind the screen. An informed guess points to at least the following areas of disagreement. First, the World Bank and IMF might have disagreement with the Ethiopian government's strategy of gradualism. Second, the Ethiopian government's implicit belief in a pragmatic mix between the public and private sector might have been unacceptable to the IMF and World Bank and, third, the IMF's and World Bank's insistences on the need for competition by doing something about the supposed monopoly position of the CBE is cautiously seen by Ethiopia. This last point is quite sensitive because Ethiopia may not be in a good shape to compete in the future if it does something, such as breaking it up, about CBE .

In general, it is my opinion that given the recent and nascent level of development in using market mechanisms in the country, given the relatively good shape in which the existing financial institutions find themselves, and given that the supervisory and regulatory activity of NBE is new and characterised by low level of capacity (in terms of human resource), the government's strategy of gradualism, institutional building and its overall reform direction need to be appreciated and be supported by the World Bank, IMF and relevant institutions.

6. Concluding Remarks

Ethiopia has embarked upon financial liberalisation in the context of 'Structural Adjustment Program' since 1992. In this paper an attempt to understand the new financial sector and its regulation is made.

The post-reform period, along with the new privately owned financial institutions, is characterised by the reorganisation of publicly owned banks so as to ensure their autonomous and efficient operation in a market-oriented economy. As discussed above, the prudential regulation aspect was well thought of and the appropriate laws promulgated. The NBE, actually aided by the uncomplicated nature of the existing banking structure, is performing a good task as a regulatory body. However, it is recommended that it enhance its capacity building in regulation and supervision as matters get complicated in the future with the proliferation of both domestic financial institutions and the inevitable coming-in of foreign banks.

On the other hand, these institutional reforms are also being accompanied by a number of related polices such as: interest rate deregulation, exchange rate liberalisation and the development of inter bank money and foreign exchange markets. The hallmark of this reform process is gradualism and institutional capacity building. This is the result of the government's recognition of the existence of structural problems that can jeopardise any financial liberalisation scheme. As noted in the paper, however, the Breton Woods institutions are uncomfortable with the speed at which the reform is being carried. Whatever the case, the analysis in this paper points to the importance and relevance of the government's policy of gradualism both from the recognition of the structural problems in Ethiopia and the experience of other reforming countries in Africa, Asia, Eastern Europe, and Latin America. It is imperative to note that institutional building is a prerequisite for successful and sustainable reform.

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