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Problem of Financing Development in Ethiopia

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Problems of Financing Development in Ethiopia

1. The Macro-Analytical Framework of the Study

The section on problems of development finance in Ethiopia will be concerned with the question of how to finance investment that will be identified in the context of the 'Concretization of ADLI and Transition to Processing' and 'Source of Growth Study'. The macroeconomic framework for understanding this problem is outlined below.

Conventional macroeconomic analysis does focus on the ex ante equilibrium between saving and investment ($I_t=S_t$). This equilibrium based analysis blurred the prime role of investment in creating saving but also disregard the role of monetary policy instruments, such as credit expansion, as in effective tools for enhancing financing development. An analysis of the saving investment relation from a disequilibrium perspective helps to vividly show, not only the prime importance of investment in creating saving but also the possible endogenous nature of money supply and hence the role of banks in ensuing the financing of development.

We will assume that there are *increased opportunities* that would lead for increased investment. Since the equilibrium between this increase investment and required saving takes, at least, one period to be equated, there must be a disequilibria at the out set where it is larger than S_t . (If we take an extreme case of one period gap between investment and the saving that it will create, the financing gap in the current period is given by $[I_t-S_{t-1}]$). This creates the demand for credit. Thus, a smooth financing of this additional investment requires that bank credits will increase by the amount of the addition investment and savings at the banks would increase by that amount profit entrepreneurs made (assuming workers do not save). As noted by Kalecki (1933), effectively, the entrepreneurs engaged in additional investment are 'propelling in to the pockets' of other entrepreneurs profit which will be equal to there investment and they are becoming indebted to them.

It can be noted from the above analysis that an expansion of investment requires, (a) increased investment opportunities which entrepreneurs anticipate will be profitable and make them think it is worth being indebted; (b) an increase in bank borrowing (credit expansion) and hence the money supply. The first one, in a country such Ethiopia relates, *inter alia*, to investment in infrastructure (including access to land), access to information (in particular on investment and business opportunities), efficient bureaucracy, policy credibility (no problem of 'time inconsistency'), and business confidence. The second point relates to the condition that the money supply may need to be equal to the investment and saving gap. In the context of the one period gap assumed earlier, this means $M_t-M_{t-1}=I_t-S_{t-1}$. This however depends on the efficiency of capital market which may reduce this requirement for expansion if it is efficient in to 'recycle' the increase savings as they arise, and the decision of those who earn the money to pay back their debt, which again reduce the expansion of money supply needed if they decide to pay back their previous debt. Thus we may have $M_t-M_{t-1}=a(I_t-S_{t-1})$. The coefficient a will be close to zero as the capital market is quicker at recycling saving and more loans are paid off by agents to the banks.

The argument presented so far although is couched in terms of investment can equally be applied to other forms of expenditure (such as government and private consumption). It can also be noted that since production, in particular in a country such as Ethiopia, takes a significant time lag, firms may expand their use of inputs ahead of an expansion in output thus requiring an early demand for financing. The important point here is that the money supply is endogenous to private sector and responds through bank loans to planned investment.

The analysis above can easily be extended to condition of an open economy with an inclusion of the government sector. This changes the basic equation to: investment equals to domestic saving plus government saving, plus foreign saving (foreign trade deficit). This may be shown using the national income accounting identity (equation 1) and re-writing it to yield the accumulation balance (equations 2 and 3) as,

$$Y = C + I + G + X - M \quad [1]$$

Where: Y is income, C consumption, G government expenditure and X and M are imports and exports of goods and non-factor services, respectively. F is the external finance (see equations 3 for definition) could be given as,

$$Y - C - G - I = X - M = F \quad [2]$$

Rearranging, we may arrive at an explicit relationship between investment and its financing given by equation 3,

$$I = S + F \quad [3]$$

Where: I is gross domestic investment, S national savings and F net capital inflows. The latter is defined as the net change in assets and liability position of the country, and is equal to the deficit of the current account of the balance of payments (i.e. the external balance), which is given as,

$$F = M - X + N \quad [4]$$

Where: N is net factor payment and current transfer *to* abroad. Combining these, disaggregated into public (g) and private (p) sectors and rearranging, yields

$$(I_g - S_g) + (I_p - S_p) = M - X + N$$

$$\left[I_g - \underset{\text{FiscalDeficit}}{(T - G)} \right] + (I_p - S_p) = M - X + N$$

$$\left[I_g - \underset{\text{FiscalDeficit}}{(T - G)} \right] + (I_p - S_p) = F_g + F_p \quad [5]$$

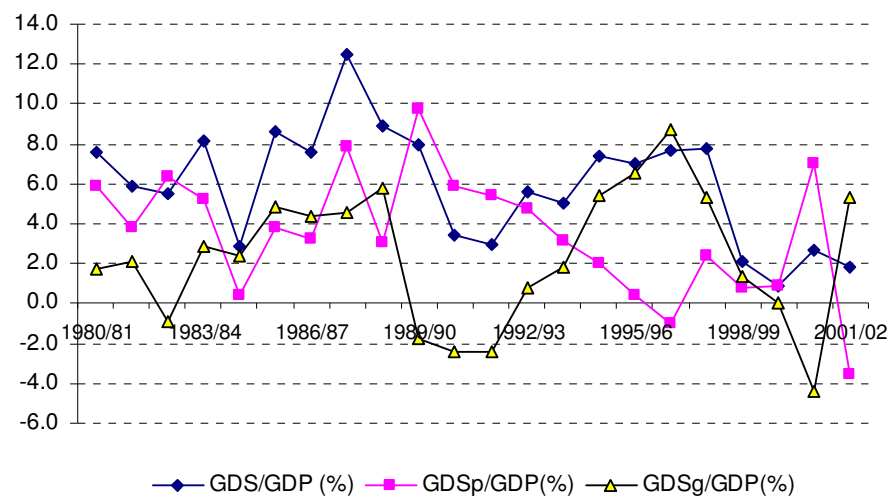
Where: T-G is the fiscal deficit and Fg and Fp are components of external finance disaggregated into public and private, respectively.

This yields the basic identity which links the domestic investment and savings gap with the current account deficit or surplus, and hence the resulting capital inflow or outflow¹. The paper thus will examine each component of this relationship in detail (domestic saving and instruments of their mobilization; external saving and external trade balance).

2. An Overview of Domestic Saving in Ethiopia

The study on the source of growth has shown the need to accelerate growth and the rising level of investment which is instrumental in achieving that. The next important question that follows from that analysis is whether this growing level of investment is financed domestically. Figures 1, 2 and 3 throw light on this issue.

Figure 1: Evolution of Gross Domestic Saving (% of GDP)



Source: Owen Computation based on MOFE Data (2004)

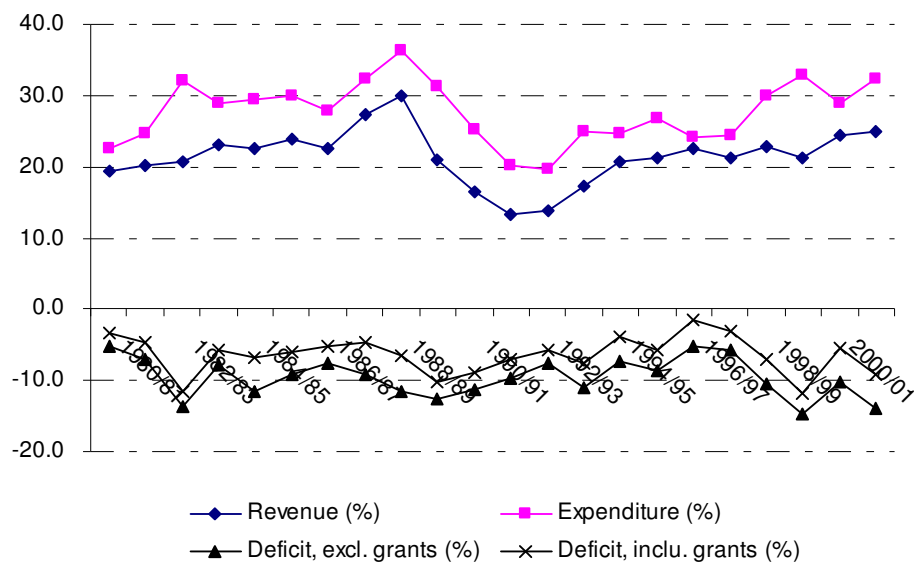
Some comments are in order about data in Figure 1. GDP at market price and gross domestic saving (GDS) data is taken from MOFED. The government saving (GDSg) is defined as the difference between the current government revenue (including grants) and current expenditure. The private saving is derived as residual. Thus, the private saving figure is highly restrictive because the gross domestic saving itself is derived as a residual (as the difference between GDP and consumption) in the National Accounts Statistics.

The data show that all types of savings have drifted in 1990/91 and private saving has steadily declined. It is interesting to note, however, that public saving is showing quite a remarkable recovery after its sharp decline in 1990/91. Following the break up of the war

¹ Having this general framework it is fairly straightforward to have a disaggregated picture. First, the stock of financial data can be disaggregated. That is, the stock data could be disaggregated according to whether creditors are bilateral, multilateral, concessional, non-concessional, or private, (i.e. banks, portfolio and other commercial suppliers). Hence, instead of using direct flows such as those reported in IMF Balance of Payments statistics, the flow counterpart could be derived from the change in stocks. This allows consistency between the stock and the flow data. (see Alemayehu 2002 and Alemayehu *et al* 1992).

with Eritrea, all types of savings started to collapse and the aggregate saving became negative. Recovery has begun following the cessation of hostilities, however. Had it not been for 'external' factors such as the war with Eritrea, the government's fiscal policy in this area was promising². However, total saving is far below the level of investment which itself is the lowest by African standard. This had resulted in the level of government deficit in the vicinity of 10 percent of the GDP per annum (see Figure 2). The government has registered a modest achievement in terms of fiscal policy chiefly by raising revenue. However, the sustainability of this result is highly questionable given the regional insecurity (including the war with Eritrea) and natural disaster that often strikes the country. The deficit also points to the country's dependence on external resource, to bridge its resource gap. This is quite apparent in the financing of government capital expenditure than anywhere else. This is shown in figure 3.

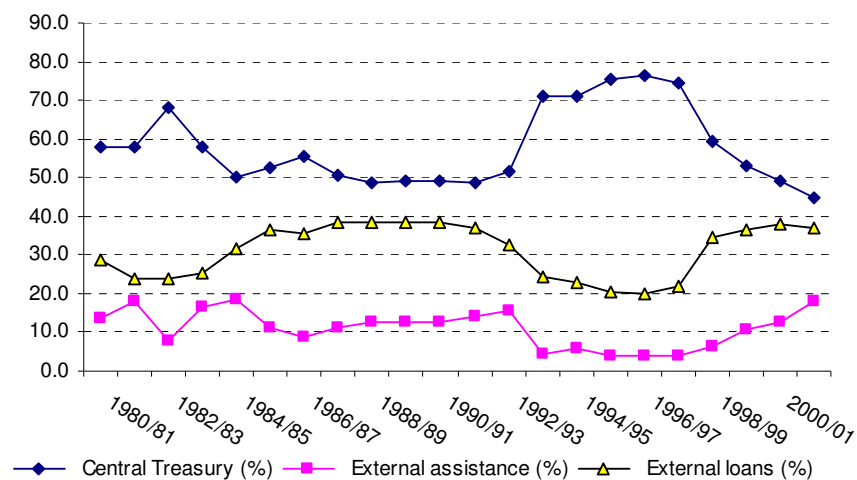
Figure 2 Government Revenue, Expenditure and Deficit (% of GDP)



Source: Owen Computation based on MOFED Data (2004)

The external assistance is largely used to finance capital expenditure. The current expenditure of the government is largely financed by its revenues, which is an interesting fiscal policy success. For instance external assistance constitutes only an average of 8 percent of the total recurrent expenditure in 1985/86 to 1990/91. This figure rose sharply to 12% in 1991/92 and dropped to an average of about 3 percent in the last decade. On the other hand the share of the external sector in financing capital expenditure (see Figure 3), which was around 38 percent in terms of loan and around 13% in terms of assistance had dropped to about 20 and 4 percent, respectively, in 1995/96, picked to 35 and 13 percent, respectively, in 2000/01. An interesting development in this period is the sharp rise in the treasury financing of capital expenditure (which rose from around 50 to 70 between 1990/91 and 1995/96, only to slide back recently (2000/01) to about 50 percent (see figure 3).

² A simple regression suggests the possibility of crowding-in in Ethiopia.

Figure 3: Financing of Capital Expenditure (% of Total Financing)

Source: Owen Computation based on MOFED data (2004)

Notwithstanding the success noted in the realm of fiscal policy, the dependence on external finance for capital expenditure needs closer attention. One important implication of a fiscal posture that tends to rely on external finance is a debt problem. As a result of the growing resource gap both the debt stock and the debt to GNP ratio have increased steadily since the 1980s (we have examined the issues in details below).

3. Domestic Saving: Saving Mobilization and Suggested Measures for Improvement

Modern theories of inter-temporal consumption choice identify four motives for *individual* saving: *retirement or life-cycle motive* (i.e. saving to *smooth* life-cycle fluctuations in income), *precautionary motive* (i.e. saving to meet *emergency* needs due to income or health risks), *asset motive* (i.e. saving to purchase *durables* and housing), and *bequest motive* (i.e. saving to accumulate resources for one's heir). We may expect retirement motive to be stronger where *income fluctuation* is high and *social insurance* is weak (e.g. major urban areas) and precautionary motive to be stronger where incomes are volatile (e.g. rural income, rain fed agriculture), *ceteris paribus*.

Governments intervene (through *incentives* and *mandatory* saving instruments - such as statutory pension schemes, compulsory car insurance) to influence both the *level* of individual saving (hence domestic savings) and the *forms* in (or *purpose* for) which they save (i.e. shape their portfolio). For example, governments commonly promote retirement saving (on the ground that having insufficient resources during retirement imposes heavy burden both on the elderly lacking such resources and society) and saving for housing and other goods of high policy *priority* such as education, health, and life protection.

Direct policies for promoting savings are important for at least two reasons:

(i) Even though capital accumulation may *follow* rather than *lead* the growth process, evidence suggests that *sustaining* high rates of growth requires substantial levels of *physical capital accumulation*; (ii) To the extent a country faces *binding lending constraints* in the international capital markets or *external balance conditionality* (imposed by bilateral and external donors), *national saving* will derive aggregate investment (Summers 1988), hence influence the prospect for *sustainability* of growth. Elbadawi and Mwege (1998) argued that “while raising saving is *not sufficient* for achieving sustained growth, it does appear to be a *necessary* condition for a higher and sustained growth” (*emphasis added*) (Elbadawi and Mwege 1998).

There are two main reasons for encouraging individual/household saving: (i) evidence shows that “even in closed economies or economies with imperfect capital mobility, *higher saving* leads to *more productive investment* and ultimately wider economic development”; (ii) “the contractual savings industry can have a favourable impact on the *diversity* and *efficiency* of the financial system, contributing to the ... establishment of *popular capitalism*, enhancing the *incentives to perform* of individuals with a *direct stake* in the holding of risky financial assets” (Japelli and Pistaferri 2002).

One could legitimately ask as to why governments should be concerned about *domestic* savings, especially in the presence of huge *international capital* which weakens the link between domestic savings and domestic capital accumulation. The two main reasons identified in the literature are that: (i) international capital *mobility is limited*, making the *link* between *domestic savings* and *domestic investment* strong. Often, international capital flows do not succeed in bridging the global savings-investment gap (FitzGerald, 2003). There is a “home bias” in acquisition of financial assets (asset holders’ portfolio preference) due to currency risk, agency problems and asymmetric information, which may partly explain the close link between domestic saving and investment (although regulatory restrictions may also be a factor). A country’s ‘quality’ of financial assets is determined by the perception among investors of its characteristics (i.e. ‘sovereign risk’, infrastructure and skill considerations, etc.). Moreover, even if capital flows are significant, the risk of reversal/withdrawal renders external private finance an *unreliable* source for domestic capital formation (FitzGerald, 2003); and

(ii) that private savings decisions involve significant *externalities*: (a) intra-personal externalities – individuals *do not fully internalize* the effect of their actions (i.e. saving decisions) on their future well being (due to, say, myopia³, time inconsistency/hyperbolic discounting, etc.), hence *save too little*; (b) inter-personal *incentive* problems – individuals, perceiving themselves as being *guaranteed a minimum living standard* (by the state, private charity, their children, etc.), may decide to *save too little*; and (c) policy based externalities – some government policies in place give less incentive for individuals to save: for example, pay-as-you-go pension programs depress the incentive to save.

Besides, reliance on foreign savings may be unsustainable: donor fatigue and increased competition for “concessionary capital inflows” are decreasing such resources (see Mwege, 2001). Developing countries are also engaged in what is known as *downwards policy*

³ Myopic individuals do not exploit tax incentives.

competition to attract FDI by providing attractive incentives (of various forms), which has a natural limit – no room for further attraction once you reach zero.

3.1 Financial institutions and financial policy in Ethiopia

Currently, the Ethiopian financial system consists of a central bank, nine commercial Banks (public and private); nine insurance companies (public and private); a public pension scheme (with three separate funds); a large number of Savings & Credit Coops (about 684 according to one source⁴); Micro Finance Institutions (MFIs); T-bills and bonds markets; re-discount facility for government papers; inter-bank money and forex markets; and a large number of Iqubs (ROSCAs).

Its structure is still characterized by concentration in terms of ownership (dominated by the state owned banks), asset portfolio (largely CBE), and geographic distribution of financial institutions (mostly in major urban centres) (see Table 1). It is also characterized by the conspicuous absence of certain types of financial institutions/markets: investment banks, lease companies, venture capital markets, private securities market (corporate bonds and stocks), and re-insurance companies are absent.

The limited available data indicates that the Ethiopian Insurance Corporation (EIC), a state enterprise, dominates the insurance business (see Table 2). Years after state owned enterprises (SOEs) were given management autonomy, including doing business with the private sector as appropriate, most still buy their insurance cover from the EIC.

Table 1: Share in capital, bank branches and forex branches⁵ (as of 2003)

Bank	% share in capital	% share of Addis branches	% share of bank branches outside Addis	% share of forex branches
CBE	59.23	37.6	59.9	31.8
DBE	16.49	1.1	13.7	-
CBB	3.12	5.4	6.6	18.2
AIB	4.39	12.9	5.3	13.6
Dashen	4.48	11.8	5.3	9.1
Abyssinia	5.46	6.6	3.1	4.6
Wegagen	2.21	7.5	5.7	4.6
United	2.85	8.6	4.4	13.6
Nib	2.77	8.6	-	4.6

Source: Computed from data obtained from Annual Reports of the NBE and respective banks

Note: CBE = Commercial Bank of Ethiopia; DBE = Development Bank of Ethiopia; CBB = Construction and Business Bank; AIB = Awash International Bank

Table 2: % share (average for the period 1994/95 – 2001/02)

Insurance company	Share in gross premium written (average period for 1994/95-01/02)	Share in industry's capital (2001/02)	Share in branch network (2001/02)
Ethiopian Ins.	61.1	42.6	27.1

⁴ Dagne Gessese (2003) Some points on saving and credit cooperatives in Ethiopia (unpublished), Addis Ababa.

⁵ In terms of loans disbursed, CBE's share has declined to 50.6% in 2001/02.

Corp.			
Africa Ins.	2.4	11.4	8.3
Awash Ins.	11.0	6.8	12.5
Nice Ins.	6.5	-	-
Nile Ins.	9.0	13.4	15.6
Nyala Ins.	3.4	13.0	11.5
United Ins.	4.1	5.9	11.5
Others	2.5	7.1	13.6

Source: Computed from data NBE Annual Report 2001.

A wide range of alternative financial instruments is lacking (more so in rural areas). Although T-bills and government bonds exist, they are not serving as *effective* alternative instruments to savers. The minimum denomination involved in bonds (Birr 2 million) renders it beyond the reach of most savers; The two years maturity period together with the absence of a secondary market render bonds *illiquid* - investors have to hold them until maturity since there is no secondary market in which they can be traded. Even if secondary market exists, number of participants is likely to be small due to the large minimum denomination. Transaction costs and inconvenience, relatively large denomination (Birr 5000), and uncertainty of able to buy T-bills (i.e. winning in the tender) render them less attractive.

Banks, insurance companies and MFIs are subjected to prudential regulation and supervision of the Basel standard (for detailed discussion and references see Gebrehiwot, 1997), which has been tightened further recently (see SBB/32/2002, SIB/24/2004, SIB/25/2004, SIB/26/2004, and SIB/27/2004) mainly in response to the weaknesses in banks and insurance companies.

The country's financial policy reserves the financial sector for Ethiopian nationals: foreigners are not allowed to participate as investors in banking, insurance companies, and micro finance institutions. Even NGOs are prohibited from directly involving themselves in credit and savings activities: Proclamation No. 40/1996 requires those involved in the provision of microfinance to be share companies owned only by Ethiopian nationals. The short-term capital inflow component of the capital account is controlled.

While competition in the insurance industry appears to be relatively high, this is not the case in banking and MFIs despite the emergence of many private banks and MFIs. While the CBE gets blamed as the culprit for the lack of competition in the banking industry, a deeper look into the issue tells a different story.

The regulation has put limits on large-exposure to single borrower and affiliated borrowers: any bank cannot lend more than 15% of its net worth to a single borrower, and a total of 30% to affiliated companies. That the limit is based on a bank's capital means that the smaller a bank's capital, the less its ability to serve large borrowers (short of co-financing). So, their small capital meant that, until June 1999, the maximum amount private banks could lend to a single borrower and to affiliated companies were not more than Birr 7 million and 21 million respectively. In other words, private banks were not in a position to compete for the lending business to corporate borrowers with

loan requirements above Birr 7 million (and a total of 21 million to affiliated borrowers). Thus, in the *upper-end* of the credit market (i.e. large loans) private banks' ability to compete was effectively constrained by their small capital, not by CBE's dominance. Even if private banks were successful in mobilizing more deposits, they could not have provided large loans without violating the limit.

Following the rise in the minimum capital requirement, private banks have increased their capital, which now ranges between Br 75 and 138 million. So, according to the limits, they can now compete for borrowers with loan requirements of up to about Birr 14 to 20.7 million (and the regulatory limits), borrowers previously served by the CBE only. A substantial improvement, but there is still a good deal of loan business (the most profitable perhaps) which private banks cannot cater for, namely large corporate borrowers.

3.2 Review of existing savings instruments and performance in Ethiopia

The range of (formal) financial savings instruments and their availability throughout the country is limited. The main instruments in existence are deposits (bank/MFI), pension/provident funds, insurance, T-bills and government bonds.

3.2.1 Savings mobilization by banks and MFIs

Total deposits in the banking system increased from Birr 6.4 billion in 1992/93 to 25.03 billion in 2001/02, an increase of 291% or about 29% per annum on the average, which is respectable. While the CBE still holds a large proportion of these, its share has declined from 94.4% in 1992/93 to 78.3% in 2001/02; the private banks, which came to existence since 1995, have managed to raise their share to just 16.6%.

MFIs are also involved in savings mobilization. As of end March 2003, they mobilized Br 284.4 million⁶, which amounted to about 75% of their outstanding loans. 40% of this constitutes voluntary savings from 135,214 individual and institutional savers (an average of Birr 743 per saver).

What is not clear however is that how much of the observed growth in deposits (of banks and MFIs) represents *portfolio switch* from other financial and non-financial assets into deposits and how much of it is newly generated savings.

3.2.2 Savings mobilization through pensions and insurance

The amount of funds being mobilized through pension & provident funds and insurance is not very large, mainly due to the small coverage (discussed below).

⁶ According to recent unpublished figures, it has reached Birr 318 million.

Table 3: pension/premium collection and number of contributors/policy holders

Year	Provident Fund*		Pension/provident fund		Life insurance	
	No.	Contribution	No. of insured persons**	Contributions (mil)	Coverage (no. of policies)	Premium collected (mil)
2002/03	6714		494,737	483	103,309	25.605
2001/02	6812		488,434	549.98	NA	23.226
2000/01	6411		482,220	544.31	NA	19.379
1999/2000	6377		476,096	520.11	NA	15.261
1998/99	5886	9,501306	470,058	458.56	NA	13.054

Sources: Data obtained from NBE Supervision; SSA;

* Data obtained from 20 private companies that have provident funds through a short questionnaire.

** ILO (2001), Actuarial and Financial Review of the three Pension Schemes administered by the Social Security Authority of the Federal Republic of Ethiopia, ILO/UNDP/ETH/R.16.

Those with pension/provident fund coverage under both the pension scheme of the SSA and private provident funds are only 501,451 (of which 336,947 are insured in the 'Civil Servants scheme and 157,790 in the 'Government Undertakings' scheme while 6714 have private provident fund). Although the *working age* population is commonly defined as those in the age category 15-64, for the purpose of pension coverage expansion, the 19-59 age category is more appropriate, given that the official age to join the civil service as permanent employee (hence become eligible for the Public Servants Pension) is 19 years and that the retirement age is 60. However, the 1999 National Labour Force Survey of the CSA gives the data for the age category 20-59, according to which the urban population in this age group is 3,161,297. So, those with coverage constitute only 15.9% of the population in the age group 20-59.

While the growth of deposits following the financial sector reform appears respectable, domestic savings still fall far short of financing domestic investment. The domestic financing gap in Ethiopia is large even by the standards of Sub-Saharan Africa (see Table 1). For the period 1990-2000, the domestic investment-saving gap averaged 9.4% of GDP as opposed to 5.8% for Sub-Saharan Africa excluding South Africa and Nigeria. Similarly, Ethiopia faced a resource gap of 7.4% of GDP during 1975-1989 compared to 1.55% for Sub-Saharan Africa excluding South Africa and Nigeria.

Table 4: % GDP share of gross domestic saving and investment

	1975-84	1985-89	1990-2000
GDP share (average) of gross domestic I:			
Ethiopia	13.7	14.7	14.4
Sub-Sah. Af. exc. S. Africa. & Nigeria	19.0	15.8	18.0
GDP share (average) of gross domestic S:			
Ethiopia	6.4	7.2	5.0
Sub-Sah. Af. exc. S. Africa. & Nigeria	15.2	16.5	12.2
Resource Gap:			
Ethiopia	7.3	7.5	9.4
Sub-Sah. Af. exc. S. Africa. & Nigeria	3.8	-0.7	5.8

Source: World Bank (2002), African Development Indicators; see also Wondwossen (2003)

Moreover, of the country's gross national savings, which is estimated at birr 7,257.2 million in 2001/02, only 12.8% was domestic savings while only 29.5% was intermediated through banks and/or MFIs (see Table 5). This, together with the absence of (at least formal) capital market in the country, suggests that resource allocation is not as efficient as it could have been if savings were mainly allocated through intermediaries and/or the capital market: presence of financial intermediaries and developed capital markets allows scarce resources to be allocated to their best uses, thereby improving both the quantity and quality of investment.

One commonly hears of banks in Ethiopia (CBE in particular) facing persistent excess liquidity problem. While this may be true, it sometimes gets overstretched to the point of almost saying that there is no capital shortage in the country. For example, looking at the data for the period June 1993 – June 2003, we see that, while banks are required to hold 15% of their *net current deposits*⁷ in the form of liquid assets (namely, cash and T-bills), their actual liquid asset holdings exceeded this by a significant margin for all the years: the actual liquidity ratio ranged between 33% (as of June 2001) and 65% (as of June 2003) for all banks (between 29.5% and 69% for the CBE). In absolute terms, these amounted to birr 3.744 billion in 2001 (of which 2.822 billion is that of CBE) and birr 12.672 billion in 2003 (of which 10.835 billion belongs to CBE). This is money that banks should have invested (loan otherwise) but did not while at the same time credit access has been a major problem to firms (see Gebrehiwot, 1998; EDRI/World Bank, 2003).

Table 5: Savings and Deposits for the period 1993/94 – 2002/03

	1993/94	1994/95	1995/96	1996/97	1997/98	1998/99	1999/00	2000/1	2001/2	2002/3
Gross domestic savings	1,426.2	2,517.1	2,652.6	3,195.0	3,466.3	(345.5)	(38.0)	1,433.9	931.4	(1,145.3)
Gross National	3,242.4	5,674.0	6,013.2	5,888.9	6,884.5	2,957.7	5,125.4	7,441.6	7,257.2	8,628.0

⁷ Defined as net deposits and similar liabilities of banks with one month maturity.

Savings										
Bank deposits mobilized (mil)	1,245.2	2,082.3	1,565.4	1,876.1	3,823.4	130.7	2,508.4	2,766.8	1,882.8	
MFI deposits	NA	NA	NA	NA	NA	NA	NA	NA	255.062	317.579

Sources: NBE Annual Reports 1995/96, 1996/97, 1998/99 and 2001/02; NBE Quarterly Bulletin Vol. 18, No, 4, 2002/2003.

It should be noted though that excess liquidity *does not necessarily mean* there is mountain of idle money in the hands of banks (as is often stated). All it tells us is that actual liquid assets of a bank exceeded the *required liquidity ratio* as of the reporting date specified by the regulator. The excess may have occurred for various reasons. It may simply represent an intermediate step by a bank liquidating one type of asset in order to *switch* to another, hence may disappear immediately. The excess may also reflect the preference on the part of banks to accumulate liquidity rather than lend to non-prime borrowers: firms facing high non-performing loans may deliberately slow-down new lending until the situation is rectified – For example, with non-performing loans (NPLs) ratio reaching 49% at end-March 2003, the CBE had to cease lending to borrowers with NPLs (with some exceptions). Excess liquidity may also be due to shortage of credit demand. So, it is only when the excess *pervists* that it represents idle money, which is the case in Ethiopia.

The following comparison may put the magnitude of the excess liquidity in perspective. According to the Large and Medium scale manufacturing industries survey (2001/02) of the Central Statistical Authority (CSA), new capital expenditure⁸ (of the 393 reporting establishments – both public & private) amounted to birr 461.29 million. So, the 3.744 billion birr excess liquidity in 2001 is equivalent to more than 8 times this new capital expenditure. According to the same survey, the average paid-up (initial) capital of the firms covered was Birr 6.01 million. Based on this, the excess liquidity in the hands of banks is enough to establish 623 enterprises of this size. According to data from the Ethiopian Investment Authority, the 45 biggest investment projects that went operational between 1992 and 1995 E.C. had a total actual investment capital of birr 4.327 billion. The excess liquidity would have financed about 86.5% of this. So, in this sense, the excess liquidity may be regarded as large. But, does it really represent capital abundance in the country such that there is no need for savings mobilization effort? Surely no.

The amount would disappear by lending to a couple of big projects – For example, of the top 100 big projects that went operational over the past 11 years, the biggest 4 alone had actual capital of over 4 billion birr: these 4 projects would have more than absorbed the entire so-called excess liquidity. On the contrary, the large and persistent domestic investment-saving gap argues for domestic savings promotion effort.

3.2.3 Remittance

⁸ Defined as “the cost of new or used capital equipment bought, cost of building and other capital goods produced or built by the establishments during the reference period”.

Remittance is another potential important source of finance. According to official statistics, annual remittance receipts increased from birr 98.1 million in 1996/97 to 328.1 million in 2002/03, with significant fluctuations in between (NBE). In fact, remittance receipts net of amount transferred abroad by foreigners working in Ethiopia are much lower: it ranged between birr 88.1 million in 1996/97 and 201.3 million in 2002/03. This figure is very low considering the large migrant and refugee population throughout the world (estimated to be close to 1 million). According to data obtained from a survey of remittance recipients (conducted in 1998 and 1999) and money transfer companies, Somaliland, a neighboring country with a smaller estimated migrant population (350,000 to 375,000), annual remittance receipts amount to US\$ 500 million (Ahmed, 2000).

However, the official figure is an underestimation: actual remittance receipts are likely to be much higher than what official statistics would suggest as remitters make their transfers in various *forms* (cash, cars, furniture, clothes, jewellery, electronic goods, etc.) using different *channels* (formal and informal money transfer operators, trusted merchants, hand-carrying by migrants or their friends visiting home, etc.). This is an area that requires further research not only to estimate the magnitude and identify the determinants of international remittance but also to understand the importance of the various forms and channels used as well as the factors that determine the use of remittance funds in Ethiopia so as to inform policymakers to design policies to harness this source of finance for development.

3.3 Some measures to promote savings in Ethiopia

Measures that promote savings are needed to narrow (if not eliminate) the domestic investment-saving gap. Savings promoting efforts (out of both *earned* and *remittance* incomes) may be directed at bank/MFI deposits; pension/provident funds & insurance companies (including rural insurance); savings for merit goods (education, health, etc.) and housing.

The measures may include a combination of *legislation* and *incentives* designed to improve availability (ease of access to) and net returns on existing financial instruments; introduce new instruments; as well as expansion of coverage, members' access to their contractual savings in case of emergency and investment outlets/opportunities and improve returns thereof. Measures that encourage remittance by Ethiopians abroad and their productive uses are also important.

3.3.1 Bank/MFI deposits:

Research shows that easy *access* to convenient and safe savings vehicles increases savings significantly⁹ (see Fry 1995; Stiglitz 1994; Stiglitz and Uy, 1996). With deposit taking

⁹ After examining public policies towards financial markets pursued by the East Asian Miracle countries, Stiglitz and Uy (1996) concluded that one of the major interventions in the financial market

institutions few and far between in rural areas, people are forced to save in kind (e.g. stocks of grain, livestock, jewellery, etc.). Provision of financial assets/instruments that suit the *needs and preferences* of rural savers and provide returns may help both in the financialisation of *existing* and generation *new* savings. However, most bank branches in Ethiopia are concentrated in major urban towns while a large proportion of the Ethiopian population lives in rural areas with little or no modern transport link, hence lacking access to financial assets. The recent emergence and expansion of MFIs, many of which focus on rural areas, is a positive development creating opportunity that should be exploited for the purpose of promoting rural savings. Encouraging MFIs to increase their outreach (for example, partly cover the overhead costs of establishing new branches/sub-branches) as well as introduce financial instruments appropriate to the conditions of rural savers is crucial in this respect.

Some MFIs seem to be making good progress in terms of savings mobilization¹⁰, although it is not clear how much of this is raised from rural savers. However, the financial savings instruments available are narrow and tend to be rigid. The only instruments on offer are compulsory¹¹ and voluntary savings. Introducing flexibility to *accessibility* of the compulsory savings by allowing savers to use at least part of it in case of emergency situations is likely to increase its liquidity, hence attractiveness. After all, the confidence those savers can quickly convert their asset holdings into cash with relative ease when they want to is one key factor in the decision to invest in financial assets (thereby making their funds available for use by others). The degree of *trust* among rural savers in MFIs is also important (in addition to the interest rate on deposits). Regulatory and supervisory measures that ensure that MFIs exercise prudence, transparency and accountability in their operations is an important step along this line.

3.3.2 Contractual savings:

One way of promoting savings is through development of contractual savings, pension/provident funds and insurance in particular.

In developed countries institutional investors such as mutual funds, insurance companies and pension funds are important sources of long-term corporate finance¹². In the context of developing countries, the success of Chile may be instructive: pension funds in Chile

that was central to the success was *promotion of savings* through (i) creation of *postal savings* and *provident funds* (which attracted *small savers* by providing them *security* and *convenient access*).

¹⁰ According to Narayana (2004), as of March 2003 savings mobilization by MFIs has reached, on the average, as high as 3/4th of their loan portfolio, with significant variation between MFIs (ranging from only 12.5% in the case of ASSER MFI to 118.5% in the case of DECSI).

¹¹ Compulsory savings are savings active MFI clients are required to contribute (to the group and Centre) regularly (usually every month), partly upfront (i.e. before taking loan) and are used as partial collateral - they are resorted to by the MFI to settle any unpaid loan obligation in the event of default. As a result, they are illiquid: they cannot be withdrawn until the whole group has fully settled its loan obligation.

¹² According to Drucker (1996), (a) the 20 largest pension funds in the US hold about 1/10th of the equity capital of publicly owned companies in the US; (b) institutional investors controlled 40% of the common stock of the country's large and midsize businesses; (c) pension funds held about 40% of medium- and long-term debt of the US' biggest companies ...showing that "these institutions have become corporate America's largest lenders as well as its largest owners".

reached 43% of GDP in a matter of less than a decade and a half to become major source of funds for investment.

Pension funds and insurance companies (life insurers in particular), unlike banks, have *contingent* liabilities; that is, they pay out claims only when the insured against event occurs. Besides, there is a time gap between the time premiums are received and the occurrence of an insured event that gives rise to claim of payment on the policy (which tends to be long in the case of life insurance in particular). During this period, the insurer could invest the funds. These, together with the *law of large numbers*, allow insurance companies to hold assets of long maturity, hence make their funds available for long-term lending without themselves becoming illiquid (i.e. still have enough liquidity to meet their liabilities). In the context of developing countries, the success of Chile using this scheme is instructive.

Development of contractual savings (pensions and life insurance) thus provides a means of increasing supply of long-term savings/finance (and national saving, provided contribution is mandatory and government does not take the funds as *captive* source of finance), in addition to increasing the options to obtain sound coverage against contingencies (such as old age, death, unemployment, severance payment), promoting financial deepening and improving financial risk management¹³ (which in turn may reduce the country risk premium and interest rates). Besides, the *long-term* nature [*in addition to being contingent*] of the liabilities of contractual savings institutions makes their *liquidity* and *premia* requirements low, thereby reducing the cost of capital. The increase in long-term savings may flatten the term structure of interest rates, thereby encouraging the undertaking of longer maturity, high-return investment projects.

A pension system designed to be affordable and provide adequate coverage, hence be sustainable, will help achieve not only redistribution but also capital accumulation. Such pension system may help promote growth through its beneficial effects on both the functioning of the labor market and the development of capital markets (Vittas, 1996) – i.e. reducing labor-market distortions and creating more efficient capital markets.

Interestingly, the requirements for successful development of contractual savings, according to Impavido, Musalem and Vittas (2002), are not that demanding: neither a full-fledged financial system with a range of efficient financial *institutions* (banks, insurance companies, etc.) nor a full range of financial *instruments*, nor sophisticated *regulatory & supervisory mechanism* are required to be in place. What is needed, instead, is a (a) core of *sound* banks & insurance companies, and (b) government *long-term commitment* to financial sector reform (as signalled by adoption of *sound and credible* macroeconomic policies) and to the *creation of sound* regulatory & supervisory framework¹⁴.

¹³ reduce refinancing risks of borrowers while funding contingent liabilities; the long term deposits of these institutions allow banks to lend long-term and at the same time reduce their maturity transformation risk.

¹⁴ Only minimum regulation and supervision that ensures licensing of only qualified institutions, timely payment of contributions, and enforcement of contracts are needed.

The question that follows is how does Ethiopia fare in terms of these preconditions? The macroeconomic environment appears stable judging by the behavior of the exchange rate, interest rate and inflation and the government's declared commitment to macro stability which is favourable for long-term saving instruments. The banking and insurance industries are subjected to regulation and supervision that meet (at least on paper) the international minimum standard set by the Basel Accord. However, *enforcement* appears weak (partly due to limited capacity of the regulator); banks are weak (as reflected in, among others, their persistent high NPLs), securities market is *non-existent* (except government bonds) while the capital account is closed; the *low per capita income* may render contractual savings (insurance in particular) unaffordable.

A) Pension/provident funds:

Reform measures designed to *expand coverage* may go a long way in increasing the amount of savings mobilized through the pension/provident fund schemes. For example, a radical pension reform in Chile in 1981 which, among other things, expanded *coverage* significantly led to growth of pension funds from 1% of GDP to 43% in a matter of less than a decade and a half to become major source of funds for investment - The reform replaced the mandatory pay-as-you-go (PAYG) state pension system by a *privately-managed* earnings-related *fully funded* system which *forces workers*, including the *self-employed*, to save part of their wage for old age, *complemented* by a small state-run re-distributive *minimum-pension* transfer program.

Coverage expansion is important both from the point of view of increasing the proportion of the population receiving protection as well as widening the membership base of (hence contributions to) the funds and generation of investable funds. A rough calculation shows that the potential for expansion of coverage of the pension/provident fund system in Ethiopia is huge. According to recent CSA surveys, the number of persons engaged in the Large & Medium scale and Small Scale Manufacturing industries are 98,986 and 97,781, respectively (of which 85,521 and 54,812 are permanent workers) (CSA, December 2002). The number of persons engaged in Cottage/Handicraft Manufacturing industries is 1,306,865 of which 1,230,846 are *active owners* (CSA, November 2002). Making the *permanent* employees of large, medium and small scale manufacturing industries as well as *owners* of cottage/handicraft manufacturing industries join a pension/provident fund will raise the number of contributors (including civil servants) to 1,699,126 (which is a growth of 238.8% over the current coverage of just 501,451), thereby raising coverage to 53.7% (from 15.9% currently) of the urban labor force (i.e. population in the 20-59 age category). Even if we exclude the 766,626 cottage/handicrafts industries owners operating in *rural* areas on the assumption that they may not be reached in the short run, membership would still expand to 932,500 (a growth of 86%).

The simple arithmetic below will help us get a sense of the *order of magnitude* such expansion in membership will lead to in terms of pension/provident funds contribution. Those insured in the 'Government Undertakings' scheme (157,790 persons) contributed in 1995 E.C. was birr 131.67 million (at 10% of income, of which 6% is employers' contribution). So, the average contribution per insured person is birr 834 per year (or birr 69.5 per month implying an average monthly income of birr 695). Assuming that the

932,500 persons engaged in large, medium and small scale enterprises and in urban cottage/handicraft industries, which are the potential target for expansion, have such average monthly earning, so that this average contribution applies, additional contribution will be birr 64.809 million per month (777.705 million a year). This is a huge increase: It is more than twice of the contributions to the 'Civil Servants' and 'Government Undertakings' schemes combined in 1995 E.C.: Contributions to the two schemes during this period amounted to birr 370.35 million. Given that entitlement for benefits requires many years of service while contributions start immediately upon joining the scheme and are regular, the expansion may lead to a significant *build up* of the fund, especially if the funds are wisely invested. A recent actuarial and financial review of the pension schemes of the SSA by the ILO reveals that under the *status quo* conditions, the schemes will face *cash-flow deficits* as early as 2004 E.C. and the reserves will be *depleted* by 2013 E.C (ILO, 2001). So, increasing the number of contributors through expansion of the pension/provident fund coverage, in addition to allowing a larger percentage of the population provide for their retirement age, is important from the point of view of sustainability of the pension. Curiously enough, the actuarial study did not consider expansion of coverage of the scheme as part of the effort towards improving the sustainability of the funds.

Employer's contributions to pension/provident funds on behalf of employees are part of the cost of labor, hence are deducted from the taxable profit/income of the employer for the period during which the contribution is made. This adds to the incentives employers have to create pension/provident fund schemes to their workers. [The other motives include to "entice workers to stay with the firm", hence reduce *turnover*; to impose *mandatory retirement* on workers whose productivity is falling due to old age; to enforce *discipline* among workers by making striking workers lose their pensions; as expression of employer's appreciation of *loyal service*; to create public *good will* for taking care of its workers at old age, etc. – see Williamson 1995]. However, employees' contributions are taxable (while pension benefits are tax-exempted); that is, employees pay personal income tax on their basic salary gross of pension/provident fund contributions. This means contributions to pension/provident funds are subject to tax. Pension/provident fund members may feel that this is punitive since, given the progressive tax system, the aggregation pushes them to a higher tax bracket. So, authorities can consider tax incentives for retirement saving by making contributions to pension/provident funds *deductible* from taxable income. Theoretically, tax incentives could also be given through full or partial tax exemption of pension benefits and returns from investment of pension/provident funds. However, there is no room for such incentives in the Ethiopian context as all types of pension benefits (retirement, disability, survivors) as well as investment returns on pension funds are tax-free.

Of course, tax shelter involves a cost in the form of *decreased state revenue* (due to forgone tax), which in turn may reduce public saving. Thus, tax shelter to contributions to pension/provident fund schemes and returns to such funds will increase national saving only to the extent that the increase in private saving due to the shelter is large enough to more than offset the loss in state revenue due to the forgone tax (cost of the tax incentive).

Currently, the pension scheme is rigid in terms of members' *access* to their savings. According to the Public Servants' Pensions Proclamation No. 345/2003, retirement

benefits are received upon reaching retirement age of 60 years (3 and 5 years *prior* to retirement age in case of *resignation* after 25 years of service for public servants and members of the Defence Force, respectively)¹⁵. This means, members who have been in the scheme for years (hence have accumulated savings) cannot even partly access their savings (say, through borrowing or making partial early withdrawal) even in case of major emergency. While one could advance arguments related to discipline-in-saving and practical difficulties involved to justify such restrictions, whether their importance really out weights the needs of members in times of real emergency situation is doubtful. Allowing **partial** early withdrawal under strict conditions in a manner that does not erode saving discipline (say by attaching penalty tax or high interest rate to it) may be worth considering to introduce some flexibility to the scheme, so as to encourage voluntary participation by employees of the private sector (including the self-employed).

In fact, the Public Servants' Pension Proclamation contains another article whose rationale is difficult to understand: article 21(3) states that a public servant "who separates from work due to resignation prior to completing then (10) years of service shall be entitled to no benefit". This means that s/he will not be paid even the 4% contribution s/he made to the fund. The legality¹⁶ of this article is very doubtful since the 4% contribution certainly is the members' own money on which s/he has paid income tax; that s/he forfeits the employer's contribution may be understandable, but not this one. What the SSA could legitimately claim at most in such cases is deduction to cover administrative expenses that may be involved. Whatever the justification¹⁷ for the article, it poses a major hurdle in the effort to expand pension coverage by including private sectors employees (including the self-employed): who would want to loose savings of 4% of years-hard-earned income just for changing a job?

B) Insurance:

Insurance in Ethiopia is at very low stage. According to data from the NBE the insurance per capita (density) for both life and non-life was only birr 6.92 in 2000. Table 7 gives the total premium collection by insurance companies and paid out as *re-insurance* premium. Gross insurance premium collection as percent of both GDP and GNP is also very small (see Annexes 2 and 3).

The number of insurance policies reached 258,761 (51,472 being that of the Ethiopian Insurance Corporation) of which *life* insurance policies account for only 40%. In terms

¹⁵ The only exception, if it can be considered flexibility, is that when a public servant separates from the service by becoming "incapable of fulfilling the medical conditions of service due to failure in health prior to attaining retirement age" access to benefits starts as of the month following ascertainment of this.

¹⁶ Of course, one may argue that it is legal since a public servant has accepted this condition as part of the terms of his/her employment contract. But, do the public service institutions in the country *explicitly state* the content of this article explicitly while employing? It is also reasonable to ask whether doing so would make any difference in deciding whether or not to accept a job, especially the high level of unemployment in the country [Thanks are due to Alemayehu for raising this point].

¹⁷ One guess is that it may be intended to discourage public servants from leaving the public service before serving long enough.

of premium, the amount collected was birr 581.2 million, 44% of which is from life insurance. However, the rate of retention is low.

Motor insurance: In recent years, the country has secured itself a leading position in the world for yet another wrong reason: this time not famine or poverty but *traffic accident*, mostly caused by reckless driving and having too many cars that are not worthy of being on the road. Motor insurance coverage is very low: Of the 123,485 vehicles (both short-and long-distance, excluding other vehicles such as motor cycles, agricultural machinery, etc.) that were on the road, only 24.5% were insured. Yet, car insurance is *voluntary* in Ethiopia (despite the common knowledge that the insurance industry in general and car insurance in particular, is ridden with *adverse selection* problem). In fact, according to information from AIO (2002), Ethiopia is one of the very few African countries where motor insurance (third party at least) is not mandatory. Unless it is made compulsory, many cars are in such a bad state making the premium so high that owners would rather not buy insurance policy. Moreover, given the high car accident many of those driving cars have been involved in accidents, which again makes the premium high, thus discourage *voluntary* participation. Of course, the rate of accident (and associated damages) in itself has become a national concern to justify introduction of a legislation that makes motor insurance compulsory so as to ensure provision of insurance (i.e. to make sure that funds will be available when damages are awarded). In addition to this, making motor insurance compulsory is desirable from the point of view of savings promotion.

A rough calculation shows that making vehicle insurance compulsory will lead to a significant increase in coverage, hence premium collection. According to data from the NBE, number of motor insurance policies sold/renewed in 2002/03 were 30,194 and the premium collected was Birr 234.86 million, giving an average of Birr 7781 per motor insurance. According to unpublished data from the Ministry of Infrastructure, there were 123,485 vehicles. So, making motor insurance *compulsory* increases number of motor insurance policies by 93,291 and the corresponding premium collection by Birr 725,897,271 (or 309%) (assuming full compliance). It is also a type of insurance with very high *retention ratio*¹⁸, which is more than 94% (i.e. the ratio of re-insurance premium paid abroad to premium collection is the lowest) – the higher the retention ratio, the higher the proportion of the original gross premium available for investment by the insurer. So, simply requiring all vehicles to have insurance in order to be on the road, in addition to the advantage of making it more likely for accident victims to get appropriate compensation, allows insurance companies to mobilize more than 1 billion birr a year, a good part of which could be made available for investment. The *loss ratio* (i.e. ratio of payment of claims to premiums collected) tends to be high given the high accident rate; For example, the loss ratio for the period 1998-2002 averaged 59.1%. However, a good part of the premium collected from motor insurance could still be invested as there is usually a time gap between the receipt of premiums and payment of claims.

Liability insurance: Another type of insurance with very small number of policies that arguably should be made *compulsory* is employer's *liability* insurance. Many countries require every employer to insure against liability for bodily injury/disease sustained by

¹⁸ retention ratio indicates the maximum loss an insurer is willing to bear for its own account from a single loss or accumulation of losses arising from an event over a particular period.

employees arising from their employment. This is not, however, the case in Ethiopia as a result of which the number of liability insurance policies in 2002/03 was only 690 (with premium collection of just 3.4 million birr), despite the fact that Large and Medium scale manufacturing enterprises alone reach 910, employing 85,520 *permanent* workers. This indicates that most private sector employers have no liability insurance. The retention ratio is relatively high – more than 50%. Making such insurance compulsory will thus increase both the number of policies and premium collection (thereby savings mobilization) substantially.

Life insurance: As insurance product, life insurance¹⁹ provides an insurance mechanism (for individuals and households) to *manage* income risk. As a financial asset, it facilitates saving by providing a *means of disciplined contractual saving* and serves as a source of long-term investment finance. However, the level of consumption²⁰ of life insurance services in Ethiopia is low. It is the type of insurance with the least presence; among the lowest even by African standards. Of the 23 African countries for which we have recent data on insurance premium, Ethiopia is one of the very few countries where the share of premium collection from life insurance in total insurance premium is very low: in 1999, for example, it was, 3.2% for Ethiopia while for all the other countries except Congo and Gambia, it ranged from 7% (for Tunisia) to 88.6% (for Lesotho) (see Table 6).

¹⁹ We may distinguish between life insurance policies providing death coverage (term life policies), those with both death coverage and saving components (whole life, universal life, and variable life policies) and those primarily serving as savings vehicle (which offer little or no coverage for mortality) (see Beck and Webb, 2002).

²⁰ Alternative measures of life insurance consumption being (i) life insurance penetration (the ratio of volume of insurance premium to GDP) measuring the importance of insurance activity in the economy; (ii) life insurance density (life insurance premium per capita) which indicates the amount each inhabitant spends, on the average, on life insurance; and (iii) life insurance in force (outstanding face amounts plus dividend additions of life insurance policies) which measures the quantity of life insurance consumption by capturing the mortality risk underwritten and savings accumulated. The first two are *flow* variables while the last one is a *stock* variable.

Table 6: Share of premium collection from life insurance in total insurance premium for some African countries

Country	% share of life insurance premium in total premium	
	1999	2000
Ethiopia	3.18	NA
Benin	20.5	19.5
Congo	0.5	0.6
Cote d'Ivoire	30.3	30.2
Egypt	28.5	30.4
Gabon	NA	13.2
Gambia	1.6	0.5
Ghana	12.2	12.17
Guinea	9.6	10.3
Kenya	23.7	27.2
Lesotho	88.6	98.8
Mali	9.0	9.2
Morocco	27.8	29.1
Nigeria	20.04	20.5
Senegal	19.6	16.3
South Africa	83.7	85.2
Sudan	5.2	0.7
Tanzania	18.7	17.9
Togo	21.9	NA
Tunisia	7.3	8.1
Uganda	8.0	11.0
Zambia	33.0	32.4
Zimbabwe	41.4	35.9

Source: Computed from data from Annual Review 2002, African Insurance Organization.

The low level of consumption of life insurance services in the country suggests that there is substantial room for expansion by extending the *reach* of the benefits of *affordable* life insurance services to the population. That the retention ratio in life insurance is high (more than 80%) is an important positive factor.

Efforts to promote life insurance should be based on sound understanding of the key determining factors. Both supply and demand side factors drive the level of life insurance consumption. For insurance companies to supply life insurance policy, they need adequate resources (human and information), adequate opportunities in financial markets to invest, adequate protection of property rights and effective contract enforcement system, all of which affect the *costs* of life insurance products, hence the ability of insurers to market and distribute policies cost-effectively.

The two main motives for buying life insurance are saving for *retirement* and *bequeath* of funds to dependents (i.e. mortality risk coverage). Demand for life insurance will thus depend on household wealth, expected income, probability of death of the primary wage earner, interest rates, administrative costs of life insurance policies, ratio of cost of the insurance to its actuarial value (commonly called policy loading factor), time preference in consumption (present value of consumption of the insured's beneficiaries, until s/he

leaves the household), and beneficiaries' relative degree of risk aversion. The determinants of life insurance consumption that economic theory suggests include *demographic* factors (young dependency ratio, education, urbanization, religion and life expectancy), *economic* factors (level and distribution of income, inflation, banking sector development, and social security) and *institutional* factors (rule of law, bureaucratic efficiency and corruption). Education, urbanization, life expectancy (ratio of old dependents), income, banking sector development, rule of law, bureaucratic efficiency/quality, and corruption are expected to affect demand for savings through life insurance positively²¹ while young *dependency* ratio, *inflation*, and *social security* are expected to have negative²² effects (Beck and Webb 2002?). A recent cross-country and panel data study (Beck and Webb 2002?) on the determinants of life insurance consumption, based on a rich data set, found:

(i) education and inflation variables to be significant and robust across countries and over time, suggesting that policy makers interested in promoting the life insurance sector should pay due attention to stability of the monetary environment and education;

(ii) the effects of income to be weak while banking sector development has significant coefficients but is *not robust* across different measures of life insurance consumption as well as across cross-section and panel analysis. However, other studies show that price stability has a positive effect on bank development.

They concluded that there is a case for "promoting price stability, financial sector reform and an efficient education system if life insurance and its many benefits are to be fully realized in an economy".

Unfortunately, however, lack of data does not permit a rigorous analysis of the determinants of life insurance consumption in Ethiopia and draw recommendations accordingly. But, provision of incentives to buyers of life insurance policy with long-term contracts (e.g. making premium payments for life insurance tax deductible) is likely to help in this direction. Introduction of rural insurance (such as life, health, disability insurance) may also be considered. The recent attempt by the Oromia Credit and Savings Share Company (OCSCO) to introduce micro-insurance to its clients seems a step in this direction.

²¹ Education increases an individual's (i) ability to understand the benefits of risk management & savings, hence his level of risk aversion; and (ii) human capital, hence the value to be protected. Family/social ties weakens with urbanization, reducing reliance on self-insurance within the family and other informal insurance mechanisms, hence increases the need to save. The longer the life expectancy, the higher the savings through life insurance. As income increases individuals may direct a higher share of their income for retirement (assuming life insurance is a superior good). A well functioning banking system may influence the demand for life insurance by enhancing consumers' confidence in Non-bank FIs such as life insurers and by providing efficient payment system which reduces insurers' costs, hence their prices. Ability of consumers to use the legal system to mediate disputes and enforce contracts with their insurer raises the value of an insurance contract, hence their demand.

²² High young dependency ratio indicates that a high proportion of the population is too young to consider saving for retirement; given that *saving through life insurance* typically provides monetary benefits over the long term, monetary uncertainty (including inflation) affects the expected returns on such savings (hence the demand for them) negatively; a social security system with high retirement savings, or benefits to young dependents of a deceased person displaces private insurance;

Re-insurance²³: Insurance companies in Ethiopia have low retention rates (see Table 7). [In fact, there is data which shows that it is among the lowest in Africa, although the data is a bit old – see Annex 4]. A significant fraction (more than 23%) of what insurance companies collect as premium leaves the country in the form of *premiums ceded* to re-insurance companies abroad since there is no local re-insuring company. Moreover, it appears to be growing over time (see Table 7). In the case of aviation insurance, premium ceded was more than 94% of annual premium collection for the period 1998/99 - 2002/03.

Table 7: Re-insurance premium as % of premium collection for the period 1994/95 – 2002/03 (all insurance companies in the country).

Year	Premium collected	Re-insurance premium paid	Re-insurance paid as % of premium collected
1994/95	300,492,000	91,650,060	30.5
1995/96	319,355,000	93,251,660	29.2
1996/97	357,167,000	100,363,927	28.1
1997/98	377,695,000	105,754,600	28.0
1998/99	400,224,000	98,737,000	24.7
1999/00	439,312,000	101,492,000	23.1
2000/01	474,487,000	121,801,000	25.7
2001/02	577,557,000	202,626,000	35.1*
2002/03	581,179,000	172,809,000	29.7

Source: Annual Reports, NBE.

* The jump in the re-insurance premium as % of total premium collected in 2001/02 mainly reflects the rise in aviation insurance premium following the September 2001 terrorist attack.

Other things being equal, a high ratio of re-insurance premium payments to premium collection (i.e. low *retention ratio*) indicates that a large proportion of the savings insurance companies mobilize flows abroad, becoming drainage on the availability of savings so mobilized for domestic investment and on foreign exchange.

Admittedly, some of the insurances underwritten requiring re-insurance may be too big to be re-insured locally even if local re-insurance company exists. For example, aviation risks are too large for any of the domestic insurance companies to retain fully; spreading the risk involved outside the national insurance market by ceding a big part of it to foreign re-insurers is thus necessary (e.g. the EIC, which is the

²³ Re-insurance is a mechanism by which insurers spread the risk of loss by insuring themselves against the largest and most difficult risks or cover their whole account to protect themselves against unexpected losses and catastrophes. Re-insurance may arise from the need to spread risk, avoid fluctuations in claims, financial limits on size of loss an insurer could assume, or the possibility of catastrophe

aviation insurer of the Ethiopian Air Lines (EAL), cedes 95% of the risk and retains only 5%). However, many of the risks for which re-insurance coverage is being sought abroad could be handled locally (thereby retaining the funds for use domestically).

Table 8: Re-insurance premium as % of premium collection by type of insurance for the period 1998/99 – 2002/03.

Insurance type	Re-insurance premium paid as % of premium collected				
	1998/99	1999/2000	2000/01	2001/02	2002/03
Aviation	94.8	102.2	95.9	97.3	99.4
Engineering	62.6	48.3	64.5	59.1	73.1
Fire	46.6	46.0	49.3	51.0	53.3
Liability	31.8	50.5	23.3	40.5	46.5
Marine	36.0	34.2	31.8	38.7	33.3
Motor	3.7	3.4	6.3	6.3	5.1
Accident & health	11.0	11.9	7.1	5.3	4.4
Pecuniary	27.0	33.4	26.1	22.1	22.3
Workmen's compensation	3.1	0.8	1.4	1.9	2.9
Life	19.9	4.0	9.5	19.6	12.6
Others		3.1	8.9	13.5	12.3

Source: Computed from data obtained from the NBE.

3.3.3 Remittance:

Another potentially important source of finance is remittance from the diaspora of Ethiopian migrants abroad. Considering the large number of Ethiopian migrant workers and refugees globally (estimated at around 1 million) and the continued exodus, international remittance flows, if harnessed systematically, could prove an important source of foreign exchange and development finance. Inflow of remittance does not necessarily increase domestic savings and capital formation and contribute to economic development though: It depends on how recipients use the transfers. Studies, mostly based on country surveys, show that remittance funds are mostly used to finance non-productive uses such as consumption (including cars, wedding and other ceremonies), residential investment, migration of another family member, etc. rather than invest in business (new or expansion) or other productive assets (see Chami, Fullenkamp and Jahjah 2003) or hold financial assets. Although systematic data is not available, casual observation suggests this to be the case in Ethiopia. Further, some studies also find

evidence that remittances have significant negative effects on *long-run growth* by lowering labor force participation [and effort] among remittance receiving families (see Chami, Fullenkamp and Jahjah 2003) and encouraging further migration. However, it should be possible to design incentives that encourage productive use of such funds and discourage their non-productive uses. In view of this, some of the policies currently in place such as the privilege to Ethiopians in the diaspora to import cars duty free and the generous grant of urban land for residential purpose may need reconsideration. The measures may include removing existing policies that distort incentives, improving the business environment, and improved availability of and return on alternative financial assets. For example, the generous land grant could be linked to productive investment rather than residential; duty free importation of vehicles could be linked to businesses; and so on. While these are just suggestions for consideration, specific recommendations would have to be based on more rigorous analysis which requires rich data set (at both household and aggregate level) which does not exist at the moment.

It should be noted that efforts to encourage international remittance to the country should include ensuring that policies in place do not encourage capital flight; not only do such outflows offset the contribution of remittance inflows but also discourage remittance itself.

3.3.4 *Improving investment outlets and returns:*

Pension schemes and insurance companies require investment outlets for their funds. While coverage expansion and new policy sales are important, equally important is investment performance of the funds - The way the funds are invested (i.e. selection of investment and maintenance) should be of concern not only from the point of view of benefits but also growth of the fund. Fund growth depends not only on the balance between pension contributions (premium payments) and payment of benefits (or claims) but also on the *returns* from investing the reserves. The latter requires, among other things, investment outlets – pension and provident funds as well as insurance companies typically invest in government securities, corporate bonds, stocks, mortgages, etc. Growth of the fund is desirable both from the point of view of covering benefits and as source of investable funds²⁴.

Pension/provident funds

Although the nature of liabilities of pension funds and insurance companies allow them to invest a good proportion of their funds in long-maturing assets as well as engage in venture capital and lease companies, this is not the case at the moment.

Currently, the Social Security Authority (SSA) is authorized to invest its funds only in government bonds, T-bills, government guaranteed loans and time deposits in banks. Actually, its investment portfolio currently is composed of only three types of financial instruments, namely government bonds, T-bills and time deposits. The portfolio is dominated by short-dated assets: In 2002/03, for example, bank deposits

²⁴ Pension funds in Chile grew from 1% of GDP to 43% in a matter of less than a decade and a half, with the result that Chile is *no more heavily dependent on foreign investment*. In fact, pension funds in Chile have grown so large that it has become necessary to look for investment outlets abroad.

(with DBE and CBB) and T-bills constituted about 77%, indicating high portfolio concentration in short-term assets. In fact, the SSA has no investment in long-term instrument since the other instrument it is holding (government bonds), accounting for 23% of the portfolio, has two-year maturity.

The portfolio return (nominal) of the SSA over the 1998/99-2002/03 period ranged between 3.3 and 4.49% (period average of 3.77%). With inflation during the same period averaging -0.38%, this gives an average real return of 4.15%.

Table 9: Portfolio composition of pension funds under the SSA and returns for the period 1998/99 – 2002/03

Investment type	1998/99		1999/00		2000/01		2002/02		2002/03	
	Portfolio share	Nominal return	Portfolio share	Nominal return	Portfolio share	Nominal return	Portfolio share	Nominal return	Portfolio share	Nominal return
Gov. bonds	36.14%	1%	32.04%	1%	29.62%	3.70%	25.88%	5%	23.06%	5.10%
Time deposits	44.04%	6%	36.20%	6%	36.83%	6%	38.64%	5.70%	35.02%	5.40%
T-bills	19.82%	3%	31.72%	2.30%	33.55%	2.10%	36.48%	2.77%	41.92%	0.60%
Portfolio return										
		3.57%		3.30%		3.94%		4.49%		3.55%
Inflation rate*	4.7		6.2		-5.2		-7.2		-0.4	

Source: Computed from Unpublished data from SSA

* General price index at national level (with December 2000 = 100) obtained from NBE Annual Report 2001/02 (which is calculated from the Regional price indices).

The effort to get recent data on how insurance companies in Ethiopia are investing their funds did not succeed. However, we have such information collected in 1998. While the data is relatively old, there may be no major reason to expect significant changes since then. According to this data, about 77% of the funds were invested in short-dated assets (bank deposits and T-bills): more than 75% of the total stock of financial assets of insurance companies (amounting to birr 555 million) was held in the form of bank deposits (with time deposits accounting for 85% of this), 1.5% in T-bills. The rest was in loans to policyholders and shares (in banks as well as enterprises). The high proportion of time deposits largely reflects EIC's time deposit holdings with the DBE and CBB.

In 2001/02 EIC accounted for about 42% of total capital, 27% of branches and 54.2% of total premium collections, while its share in life insurance (in terms of premium) exceeded 92% (computed from NBE Annual Report). Although there is no data on the investment and returns of insurance companies, given its share in the industry, the following data on EIC's investment activities of its life insurance fund may give us a good indication regarding insurance companies' returns on their investments. The over all return on EIC's investment is respectable.

Table 10: EIC's investment earnings for the period 1981/82 – 2001/02

	Total interest earned on investment fund (%)	Interest earned on:		
		Policy loan	Mortgage loan	Fixed deposit
1981/82	6.15	6.66	8.28	5.77
1982/93	6.19	6.5	12.7	5.54
1983/84	6.5	7.11	6.62	5.76
1984/85	6.04	6.72	9.03	5.8
1985/86	2.11	0.62	16.83	1.0
1986/87	1.25	5.65	8.76	0.87
1987/88	1.59	5.62	5.98	1.1
1988/89	2.17	5.36	6.9	0.9
1989/90	2.51	4.88	7.25	1.0
1990/91	2.99	5.1	8.07	1.46
1991/92	2.54	5.11	8.63	1.0
1992/93	2.86	5.88	7.24	1.04
1993/94	4.03	5.96	7.61	2.79
1994/95	9.88	5.83	8.68	10.39
1995/96	9.17	7.52	8.9	9.38
1996/97	7.94	6.9	8.25	7.94
1997/98	6.78	6.82	8.38	6.67
1998/99	6.29	6.34	8.49	6.09
1999/2000	5.97	5.6	8.7	5.79
2000/01	5.44	5.42	8.1	3.26
2001/02	6.85	5.01	7.9	1.21

Source: Computed from EIC financial statements.

Strong investment *performance* supports growth in *policy sales* and future portfolio expansion. Since premium rates are a competitive factor, high investment *returns* are crucial in maintaining and improving a life insurance company's sales position. Investment performance is important to life insurance company in two ways: (a) investment returns add to the asset base; (b) high investment returns aid in selling additional policies – as the rate of return on investment increases, the company can lower the premiums it charges on new policies since higher rates of return provide higher earnings on reserves (cash values) and lessen the need for premium revenues. Thus, insurance companies try to earn the highest rate possible on investments, consistent with risk objectives, because policy *premiums* are related to investment performance.

However, *safety* of the principal is also paramount because the *solvency* of the insurance company and the financial security of the policyholder depend upon the future value of the portfolio being at least equal to the life insurance contract obligation. The *penalty* for a substantial portfolio loss may be much more important than the *benefits*

from an unexpectedly large portfolio gain. Thus, insurance company managers invest in securities with a *low risk* of loss - important assets are corporate bonds and stocks, mortgages, and policy loans. For *prudential* reasons, regulators also impose investment *limits* on reserves of insurance companies in the form of minimum % of reserves that should be invested in government and central bank securities and upper limits on investments in other assets – example, requiring at least 30% of reserves to be invested in government bonds; investments in *bank deposits* not to exceed 25%; investments in *real estate* not to exceed 20%; investments in *listed shares*, securities of pension and health insurance *self-governments* and securities of *public utilities* not to exceed 10% each; not more than 5% each be invested in local government securities, mortgage bonds and unlisted shares²⁵.

The concentration of short-dated assets in the portfolios of the SSA and insurance companies may largely reflect the *absence* of a wide set of alternative financial assets of long maturity to invest in (and their inability to invest in foreign assets due to the *closed capital account*) rather than a deliberate investment choice (i.e. absence of alternative assets/investment outlets is the *binding* constraint). Introducing government bonds of long-maturity and establishing a corporate bond market sooner rather than latter may be desirable in this respect. Establishment of equipment leasing companies is also one potentially promising investment area the insurance companies may seriously consider. They may also consider lending to the rapidly expanding MFIs.

4. External Finance & External Balance: Issues of Debt

4.1 An Overview: The African and Ethiopian Debt Problem²⁶

One of the major external problems of African countries relate to external finance and its manifestation in the form of debt crisis. As can be seen from Tables 1 and 2, the total external debt of Africa (and Sub-Saharan Africa) grew nearly 17 (and 20) fold, from its relatively low level of US \$16.3 (and 11) billion in 1970 to nearly US \$280 (and 223) billion today. The most important component of this being long-term debt outstanding. The use of IMF credit became important in the late 1970s and early 1980s when structural adjustment and enhanced structural adjustment facilities became important components of financial flows to Africa.

Although the share of African debt in the total debt of all developing countries' is very low (Sub-Saharan Africa share is about 9 percent between 1995 and 2000), its relative burden is very high. Another dimension of the structure of African debt is the changing pattern of its creditors. Based on Table 1, bilateral debt is the most important component of the total African debt. About a quarter of the Sub-Saharan Africa debt is owed to multilateral debtors. The bilateral and private debtors account for 35 and 14.4 percents, respectively. Private inflows are showing a declining trend (see Table 1). A final observation is that a larger share of the official debt is on concessional terms. It is also interesting to note that

²⁵ The recent directives introduced by the National Bank of Ethiopia represent explicit moves along this line (see NBE Directive No SIB/24/2004; SIB/25/2004; SIB/26/2004; and SIB/27/2004).

²⁶ This section draws from Alemayehu Geda (2003) *Eastern Africa Social Science Research Review*, Vol. XIX, No.1, pp.59-89.

the debt problem is aggravated by capitalization of interest and principal arrears, which constitute nearly a quarter of the external debt (See Alemayehu 2000a, 2003 for detail). In fact, the net transfer *from* Sub-Saharan Africa (to the developed world) between 1995-2000 was about US\$ 3 billion, the corresponding figure for all developing countries being about US\$ 23 billion (see Table 1).

Table 1: Africa and Other Debtor Regions
(Average Annual Figures, in billions of USD, unless stated otherwise)

		1970-74	1975-79	1980-84	1985-89	1990-94	1995-2000
Total debt stocks (EDT) (DOD, US\$)	SSA	11.0	32.8	77.0	136.6	190.3	223.3
	All LDC	104.1	323.2	780.3	1219.2	1673.5	2400.2
	South Asia	15.6	28.1	48.6	91.2	143.8	160.2
	L. America	46.7	139.6	340.7	442.9	522.7	742.9
Multilateral debt/Total debt (EDT) (%)	SSA	12.5	13.0	13.5	18.9	23.1	24.7
	All LDC	10.0	9.0	8.6	12.5	14.2	13.1
	South Asia	18.6	22.1	26.5	28.9	32.4	36.9
	L. America	8.9	6.6	5.6	10.2	12.2	10.8
PPG, bilateral (DOD, US\$)	SSA	47.7	35.8	30.4	36.9	39.3	35.1
	All LDC	33.7	24.7	20.6	23.9	27.9	22.3
	South Asia	69.8	64.9	44.9	35.9	35.3	31.7
	L. America	14.0	12.6	11.4	14.4	19.1	12.8
PPG, private creditors (DOD, US\$)	SSA	23.1	25.9	26.3	23.8	16.8	14.4
	All LDC	21.6	29.5	34.7	39.7	31.2	26.3
	South Asia	4.8	3.4	8.6	17.4	18.7	18.1
	L. America	28.3	39.9	42.4	52.2	38.9	32.8
Aggregate net transfers (US\$)	SSA	1.4	5.1	7.6	9.6	11.8	12.0
	All LDC	6.6	27.2	23.0	2.6	89.0	173.8
	South Asia	1.5	3.0	5.2	7.8	6.7	6.3
	L. America	3.2	10.6	1.4	-17.8	16.0	56.3
Net transfers on debt, total (NTR, US\$)	SSA	1.6	5.3	5.9	2.9	1.9	-2.7
	All LDC	13.1	44.2	17.8	-23.8	19.2	-22.7
	South Asia	1.3	1.5	4.2	4.0	0.2	-3.2
	L. America	5.9	17.4	-4.0	-24.9	0.7	-8.7

Source: Author's computation based on Global Development Finance 2001 (The World Bank)

Note: SSA = Sub-Saharan Africa ; LDC = Least Developing Countries

Net transfer = Loan disbursements less amortization and interest payment [as defined in World Debt Tables]

Aggregate net transfer = Aggregate net resource flows (Loan disbursements less amortization) plus official grants (non-technical) and foreign direct investment (FDI) less interest payment and FDI profit [as defined in World Debt Tables]

Like the rest of Africa, in Ethiopia, both the debt stock and the debt to GNP ratio increased steadily since the 1980s. Ethiopia's debt is characterized by the significance of military-related debt. The debt data in Ethiopia is problematic²⁷. Be that as it may, the available data shows the growing resource gap which lead to growth of both the debt stock

²⁷ See Alemayehu and Befekadu (1999) and Alemayehu and Daniel (1999) where this issue is discussed at length.

and the debt to GNP ratio since the 1980s. This makes Ethiopia one of the SSA countries that have a total debt to GNP and debt to export ratios of 204 and 1787 percent, respectively in 1994 and now declined to 92 and 583, respectively (see Table 2)²⁸. This has resulted in severe debt servicing difficulties and accumulation of arrears. The accumulation of arrears on debt emerged in the 1980s. Prior to this period, there had been almost no interest arrears and principal arrears were negligible. Interest and principal arrears that had been 0.3 percent of exports (or 0.02 percent of GNP) had reached a peak of 580 percent of exports (or 80 percent of GNP) in 1996. This rising level of arrears is due to resources constraint that hindered timely debt-service payments, i.e. meeting the debt-service obligation on schedule could only be accomplished by further debt rescheduling. This has worsened the situation as it resulted in an even larger accumulation of arrears. This problem is at least temporarily alleviated following the recent debt cancellation (see Table 2).

Table 2 Indicators of Debt Burden

G.C.	Total* Debt Stock Billion US \$	Debt/ GNP (percent)	Debt/ Export (percent)	Interest /Exports (percent)	Debt servi /Exports (percent)	Arrears GNP ratio (percent)	Arrears Export ratio (percent)	Interest arrears total arrears (percent)	Principal arrears total arrears (percent)
1985	5.2	78.0	932.1	8.8	28.4	0.02	0.3	21.4	78.6
1986	6.1	88.5	891.0	8.8	32.6	0.02	0.2	27.3	72.7
1987	7.4	99.6	1150.4	10.7	38.9	0.7	8.5	6.7	93.3
1988	7.7	101.1	1189.0	14.8	47.7	0.2	2.4	10.2	89.8
1989	7.8	99.2	1034.8	11.2	40.1	0.9	9.1	23.0	77.0
1990	8.6	127.1	1275.7	8.7	34.9	4.1	41.2	15.3	84.7
<i>After Reform</i>									
1991	9.1	172.7	1666.7	8.3	25.2	20.6	199.3	15.2	84.8
1992	9.3	169.2	2036.9	10.3	23.9	32.2	388.1	14.5	85.5
1993	9.7	157.7	1889.3	5.7	18.5	39.7	475.6	13.8	86.2
1994	10.1	208.6	1787.4	7.8	19.8	66.4	568.8	12.3	87.7
1995	10.3	180.2	1276.3	7.8	19.1	71.1	503.4	10.7	89.3
1996	10.1	168.9	1222.0	6.7	42.1	80.2	580.0	10.0	90.0
1997	10.2	160.3	968.6	4.5	9.6	84.3	509.4	10.2	89.8
1998	10.4	159.9	975.8	4.7	11.2	89.6	546.8	10.4	89.6
1999	5.5	86.9	586.9	6.1	16.4	11.0	74.2	8.9	91.1
2000	5.5	87.0	548.5	5.3	13.8	11.4	71.7	9.0	91.0
2001	5.7	92.3	583.5	6.4	18.7	10.4	66.0	7.4	92.6

* Includes Debt owed to the former USSR estimated around 4 to 5 billion US \$

Source: Global Development Finance 2003 (World Bank CD-ROM)

Generally the increasing debt to GNP and debt to export ratios, in addition to interest and principal arrears, show an unprecedented increase in the level of the country's debt. The indicators listed above revealed that on the average the total debt is well above the nation's GNP and many fold of total exports. This points to the fact that the debt burden, as compared to the country's capacity, is too heavy to take care of itself. Similarly, the debt service ratio, that was around 3 percent (per annum) during the period 1973-1983 jumped

²⁸ About 80 percent of the debt owed to the former USSR (about US\$ 4.8 bln) is recently cancelled. Multilateral lenders have also followed suit by canceling about US\$1.9 billion in the context of the HIPIC initiative, thus reducing the stock of debt by half – to about US\$ 5 billion (see Table 1).

to 28 percent in 1985, 40 percent in 1989, dropped to 19 percent in 1995 and picked to a staggering 42.2 percent in 1996 only to drop to 9.5 percent in 1997 and again rise to 19 percent in 2001. This volatile trend is largely attributed to the rise in exports, rescheduling episodes and debt cancellation (see Alemayehu and Daniel 1999).

Net transfer on debt has shown an increasing and positive trend until very recently (except in 1994/95 where Ethiopia had recorded a negative inflow of Birr - 74.6 million). However, this figure computed for the whole of Africa shows that there is a net resource outflow starting from 1980s. For instance the net inflow to Africa was -1.71 billion, -4.41 billion -4.68, -7.47 and -6.75 billion U.S dollar in 1985, 1990, 1992, 1996 and 1997 respectively (see Alemayehu, 2003). The aggregate net resource flows on debt in Ethiopia (which is the sum of net resource flows on debt, foreign direct investment (FDI), portfolio equity flows, and official grants excluding technical co-operation) has exhibited an increasing trend, even if there was almost no FDI, excepting MIDROC Ethiopia Pvt Ltd Company's (the dominant company) investment, and portfolio equity flow. This is mainly because of the rising level of financial grants (See Table 3).

Table 3: Net Resource and Aggregate Resource Flows (in million USD)

	1980	1985	1990	1995	1999	2000	2001
Net resource flows on debt (NRFD)*	94.0	560.4	203.5	133.0	134.3	90.1	454.8
Net transfer on debt (NTD)**	66.5	511.3	144.8	70.3	77.0	37.0	392.3
Aggregate Net Resource flow (ANRF)**	218.5	1101.1	837.9	630.2	568.7	673.6	857.0

* NRFD = loan disbursed minus principal repayments

** NTD = NRFD minus interest payments

*** ANRF = NRFD plus FDI, portfolio equity flows, and financial grants

Source: Global Development Finance 2003 (World Bank)

Most financial flows to Ethiopia come from official creditors (i.e. multilateral and bilateral sources). The private creditors such as suppliers credit constitutes a small fraction of the total financial flow (less than 10 percent in the period 1987-94). Out of the total outstanding debt (DOD), the average share of the multilateral and bilateral lenders during the period 1973-1990/91 was 45 and 55 percent, respectively. During the post-Derg period there is a shift towards multilateral lenders owing to structural adjustment related funds. In the period 1991/92-1994/95 from the total loan and grants extended to Ethiopia 46 percent has been mobilized from multilateral sources, 53 percent from bilateral and 8 percent from UN agencies. Among the multilateral lenders, the World Bank group is Ethiopia's main creditor. The breaking down of the total share of bilateral lenders into OECD and CMEA countries exhibited that during the period 1973-1980 the share of CMEA countries was 7 percent of the total bilateral flows while the OECD countries' share was 87 percent. Subsequently CMEA's share rose, for obvious political reason, and reached 37 percent of the bilateral flows during the period 1981-1991/92. This share sharply declined, owing to the political winds of change, to 18 percent in 1994/95. OECD's share remained fairly stable at around 51 percent in 94/95 (see Alemayehu and Daniel 1999 for detail).

The terms and condition of this debt creating flow is given in Table 4. In general the terms of borrowing in the post-Derg period were good. Thus, the average interest rate, compared to 1970, had declined by about 80 percent in 2001, the average grace period increased from

7 to 12 years and the average grant element had risen from 45 percent to 80 percent during these two periods. In terms of institutional category, loans from the official creditors, in particular of multilateral lenders, are softer than that of the private. The rising share of dollar in the currency composition of the Ethiopian debt is also a favorable trend as most of Ethiopia's export earning (from which it pays its debt) is earned in that currency – thus being insulated from currency fluctuation related costs.

Table 4: Average Terms and Conditions of all Creditors

	1976	1980	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Average interest (percent)	4.4	3.6	6.6	4.7	1.0	1.7	1.1	1.0	2.2	2.4	0.6	0.0	0.8	0.8
Average maturity (years)	33.0	19.2	21.7	20.3	40.0	40.6	40.3	36.3	30.4	33.5	40.6	17.7	38.8	40.9
Average grace period (years)	6.9	3.8	3.5	6.0	9.8	9.8	9.3	9.3	7.6	7.4	10.1	8.7	10.1	11.7
Average grant element (percent)	44.5	39.5	23.7	36.0	73.6	72.8	71.6	76.1	62.1	60.7	81.3	70.4	79.5	80.8
Currency composition of L-T debt, U.S. \$ (%)	41.9	64.5	24.2	26.1	27.6	28.6	29.2	29.0	26.8	27.6	28.1	74.9	76.0	77.9

Source: *Global Development Finance 2003 (World Bank CD-ROM)*

Grants, which may take the form of financial flows and technical co-operation, had also increased in the post-*Derg* period; this is excluding relief and rehabilitation grants, which are also very high (see Table 4). It is interesting to note from Table 4.4 that the total grants from both multilateral and bilateral sources in the periods 1985-2001 add up to be ETB 11.3 billion, of which the technical co-operation grants accounts for about 25 percent. In sum, the analysis in this section shows the serious debt problem the country is facing. The country does qualify for the HIPIC initiative and recent debt cancellation and rescheduling shows this realization²⁹.

Table .5 Development Related Grants (in Millions of US Dollars)

Years (G.C)	Total Grants	Financial Grants (percent of total grants)	Technical assistance (percent of total Grants)
1985	618.8	83.2	16.8
1986	562.7	79.5	20.5
1987	492.5	70.2	29.8
1988	774.9	74.6	25.4
1989	616.6	62.0	38.0
1990	854.1	70.7	29.3
1991	985.4	79.3	20.7
1992	1071.2	82.7	17.3
1993	728.6	77.2	22.8
1994	760.4	83.9	16.1
1995	639.8	74.3	25.7
1996	593.2	66.3	33.7
1997	508.8	70.2	29.8
1998	549.0	78.4	21.6
1999	465.3	76.6	23.4
2000	552.1	77.0	23.0
2001	553.6	74.6	25.4

²⁹ See Alemayehu and Daniel (1999) for details of the HIPIC initiative in Ethiopian context and Alemayehu (2003a) in the African Context.

Source: Global Development Finance 2003 (World Bank CD-ROM)

4.2 External Finance and External Balance: A Numerical Model Approach.

4.2.1 International Comparisons

There are several sources of external finance for development potentially available to Ethiopia: overseas development assistance, which is available on concessionary terms because of the country's low income status; foreign direct investment by international corporations; inward remittances, which we divide into household transfers and commercial transfers; and commercial borrowing. Given that the first three have the potential to cover Ethiopia's external resource needs, the last is not considered because of its high cost.

Because Ethiopia is a country in dynamic transition to a market economy, the level of external resource flows since that transition began may not be an accurate indicator of level that can be reached in the future and sustained. To consider what might be the sustainable levels of ODA, remittances and FDI, it is indicative to inspect the experience of other African countries. Many of the countries of the region are quite small, with limited possibilities for economic diversification. Therefore, to make comparison relevant, the analysis takes the set of sub-Saharan countries with populations greater than ten million (excluding South Africa), nineteen countries of which Ethiopia is the second most populous after Nigeria.

Over the period 1990-2001, the levels of ODA varied dramatically among countries and over time, from almost ninety percent of gross national income for Mozambique in 1992, to less than one percent for Nigeria in almost every year. Within this variation, clear patterns emerge. First, the level of aid to the region declined over the period. The average across countries fell from a range of fifteen to twenty percent for 1990-1995, to ten to fourteen percent for 1996-2001. The cross country average was repeated for Ethiopia, 19.1 percent for 1992-1995, falling to 10.8 for 1996-2001.

Third, a consistent pattern emerges, indicating that more populous countries tended to receive proportionately less ODA than less populous ones, and the level was negatively related to per capita income. Table 6 reports the result of testing the hypothesis of correlation among these three variables. While the results do not indicate causality in the absence of a formal model, they strongly suggest that the share of ODA in GDP is negatively affected by level of population and per capita income. One might speculate that the former variable's negative effect reflects that major donors and lenders have an implicit limit to the assistance to any country, derived from a desire to spread their funds over as many countries as possible, in order to maximize influence. The negative effect of the second variable, per capita income, is consistent with the objective of many agencies, especially bilateral ones, to focus assistance on the poorer countries. The hypothesis test in Table 6 produces a predicted value for Ethiopia of slightly less than ten percent of GDP, which is close to the actual level for 1996-2001.

If we make the simplifying assumptions that trade in 'invisibles' is balanced, that foreign investment and remittances are zero, and that debt relief substantially reduces Ethiopia's debt service payments, then the predicted value of the level of ODA can be used as an

indicator of the country's sustainable trade deficit as a portion of GDP. This statistic is used as the sustainable upper limit in the growth scenarios presented below.

Table 6:
ODA as a Function of Population and Per Capita
Income, 19 sub-Saharan Countries

Dependent variable: ODA as Percentage of Gross National Income (All variables are the average, 1990-2001)			
<u>Variable</u>	<u>Coefficient</u>	<u>T-stat</u>	<u>Signif</u>
Constant	10.832	4.58	.01
Population	-.883	-4.32	.01
PCY (PPP)	-.832	-2.70	.02
Adj R ²	.532		
F-stat	10.78		
DF	16		
	Predicted		
	value for Ethiopia =	9.7	

Notes: Observations are the nineteen sub-Saharan countries with populations greater than ten million in 2000. Data from World Bank, *World Development Indicators 2003*.

4.2.2 Remittances and Foreign Direct Investment

Before presenting those scenarios, further discussion of remittances and foreign direct investment is necessary. Table 2 indicates the relative importance of remittances and FDI for the nineteen most populous countries of the sub-Saharan region (excluding South Africa). With regard to remittances, the lack of data for several countries makes it more instructive to look at maximum values. For the period as a whole, 1990-2001, the maximum average value was 4 percent (Mali), and 6.8 percent for 2000 (Sudan). The annual and period average values for Ethiopia all fall below one percent of GDP. Unlike for Burkina Faso, Mali and Sudan, Ethiopia's inward remittances do not come from large numbers of people working in low-skilled jobs in other developing countries, but from a Diaspora population, in the United Kingdom, Sweden, and the United States, among others. This Ethiopian Diaspora population includes people who are relatively well-off, in some case rich.

A well-know characteristic of household-to-household remittances is that they tend to be used in the receiving country for consumption expenditures or construction of residential housing, rather than for productive investment. A survey of the evidence indicates that no government has been successful in altering this expenditure pattern. Further, in Ethiopia, where the manufacture of both non-durable and durable consumer goods is small, remittance expenditure will tend to have a high import content. Thus, even if Ethiopian household-to-household remittances were to reach three or four percent of GDP, which is unlikely, this would have very little net effect on the foreign exchange available to cover imports.

Much more important as a potential source of external saving and productive investment would be 'commercial' or 'business' remittances. We define commercial remittances as direct investments by Ethiopians abroad in business ventures within the country. Fostering this type of remittance would be part of investment policy, and has been

extremely important in a few countries with major regime changes of the type that has occurred in Ethiopia, Vietnam being the most obvious example.

With regard to remittances, one can conclude that household-to-household transfers are unlikely to contribute to either net foreign exchange or to productive investment. Business remittances have the potential to increase investment; but not to yield substantial net foreign exchange, as discussed in the context of FDI (discussed below). Table 7 shows with the exception of Angola, no sub-Saharan country with a population over ten million received an annual average FDI inflow of four percent of GDP (1990-2001). Indeed, in only four countries did it exceed two percent (Angola 10.4, Mozambique 3.7, Nigeria 3.8, and Zambia 3.4). Two of the four countries above two percent were petroleum exporters (Angola and Nigeria), one attracted most of the investment via a single power sector 'mega-project' (Mozambique), and the fourth attracted its relatively high flow via major privatizations of state enterprises (Zambia). The clear conclusion is that, because it is unlikely to become a major petroleum producer or have large enterprises to privatize, Ethiopia is unlikely to sustain an FDI inflow above the two to three percent of GDP range.

Table 7:
Inward Remittances and FDI as a Percentage of Gross National Income and GDP, 1990-2001

Country	Inward	Remittances	Foreign	Direct Inv't
	2000	Average 1990-2001	2000	Average 1990-2001
Angola	.0	.0	9.9	10.4
Burkina Faso	2.2	3.8	1.0	.5
Cameroon	.0	.1	.4	.2
Congo, Dem. Rep.	na	na	.5	.1
Cote d'Ivoire	na	.0	2.2	1.5
Ethiopia	.8	.2	2.1	1.1
Ghana	.7	.3	2.2	1.4
Kenya	na	.0	1.1	.3
Madagascar	na	.3	2.1	.7
Malawi	.0	.0	2.6	1.8
Mali	3.2	4.0	4.4	1.8
Mozambique	.0	.3	3.7	3.7
Niger	.8	.6	1.1	.6
Nigeria	na	2.8	2.3	3.8
Sudan	6.8	3.8	3.5	1.3
Tanzania	na	na	2.1	1.4
Uganda	.0	.0	2.7	1.8
Zambia	na	.0	3.8	3.4
Zimbabwe	na	.0	.3	1.2
Average	na	na	2.5	1.9
Maximum	6.8	4.0	9.9	10.4
	(Sudan)	(Mali)	(Angola)	(Angola)

Notes: See previous table. For the 228 country-years, 1990-2001, fourteen had FDI greater than five percent (6.1 percent of 228).

If this conclusion seems too negative, it is useful to look at the experience of the developing countries that have been the major recipients of FDI over the last decade,

which are listed in Table 8. The three countries with the highest inflows relative to GDP during 1990-2001 were Vietnam, Malaysia, and China (all four percent or over). None of the others, listed in Table 8, had an average as high as three percent. It is worth noting that for these eleven countries, there is no correlation between FDI inflows and the share of gross investment (gross domestic capital formation) in GDP; i.e. FDI does not appear to increase the rate of investment. Mainstream economic analysis provides an explanation why there should be not positive correlation between FDI and total domestic investment (FDI and by national sources): at any moment, the investment opportunities available in a country are determined by the state of the economy (e.g. the growth rate, resource endowments); foreign investment will result in a net increase in national investment only if they seize on opportunities that domestic investments cannot, for technical or other reasons.

Table 8:
Foreign Direct Investment, Gross Domestic Capital
Formation and GDP Growth, Selected Countries,
1990-2001

Country	FDI/ Max Value	GDP Average	GDCF/ GDP	GDP growth
East SE Asia				
China	6.4	4.0	38.2	9.4
Indonesia	2.7	.4	25.6	4.7
Korea, Rep.	2.3	.8	33.2	6.2
Malaysia	8.8	5.3	34.9	6.8
Philippines	3.5	1.8	21.6	2.9
Thailand	6.3	2.7	34.1	4.9
Vietnam	<u>11.9</u>	<u>6.2</u>	<u>24.6</u>	<u>7.3</u>
average	6.0	3.0	30.3	6.0
max value	11.9	6.2		
Latin America				
Argentina	8.5	2.6	17.3	3.3
Brazil	5.5	2.2	20.9	2.0
Mexico	4.0	2.4	22.8	3.3
Peru	<u>7.3</u>	<u>2.8</u>	<u>20.7</u>	<u>3.0</u>
average	6.3	2.5	20.4	2.9
max value	8.5	2.8		

Note: For the eleven countries, there is no significant correlation between FDI and GDCF. The relationship between FDI and the growth rate is non-significant at .05.

It is not necessarily an argument against FDI even when it 'crowds-out' domestic investment, because FDI may transfer technology and skills unavailable to domestic investors. However, it does imply that fostering FDI is not fundamentally a tactic to increase total investment, but a tactic to increase the quality of investment. Recognition of this implies the need for policies to discriminate among foreign investment projects. Analogously, fostering FDI is not a tactic to generate net foreign exchange, since a much of the investment will be used for imports of capital and intermediate goods specific to the investment project in question. This is especially the case for a very underdeveloped country such as Ethiopia, which has tiny intermediate and capital goods industries. Given the underdeveloped nature of the financial sector in Ethiopia, a large portion of the FDI may not flow through the banking system be directly finance associated imports.

One can conclude by saying that neither household remittances nor FDI are likely to provide substantial external finance for covering imports not directly associated with those flows. This conclusion supports the argument made above, that for the foreseeable future, Ethiopia's sustainable trade deficit will be determined by ODA flows. We now consider the relationship between the external debt and sustainability of the external account.

4.2.3 Closing the Trade Deficit with Rapid Growth

Ethiopia's debt burden is not the binding constraint to achieve a sustainable external balance for Ethiopia. On the contrary, the ratio of total debt service to exports in 2001, about fifteen percent, would be considered quite manageable in most countries. This should not be interpreted as implying that debt relief is not important, for reducing debt service would free resources to apply to public investment, which in its self would increase the rate of growth. However, the binding constraint on the external sector is the present size of the trade deficit, which is unsustainable at almost seventeen percent of GDP, seven percentage points above ODA flows. The central policy challenge presented by the external account is how to reduce that deficit to around ten percent.

A trade deficit in Ethiopia substantially above ten percent, if not covered by sustained and predictable non-debt flows, is unlikely to be sustained in the medium term. If the trade deficit were not reduced, and covered by external loans, the result would be the repeated need for debt reduction. In other words, debt reduction alone would not create a sustainable external balance. This is a problem common to a number of African countries and to some post central planning economies outside of Africa. We now consider various scenarios by which Ethiopia could move from its present stability-threatening trade deficit to one that would be consistent with sustainable, robust growth. The key elements of these scenarios are the following:

- 1) the government's growth target of six percent or higher;
- 2) reducing the trade deficit to about ten percent of GDP;
- 3) total debt service not greater than twenty percent of exports (which proves a non-binding condition); and
- 4) a maximum feasible ratio of exports to GDP.

The last element requires explanation. In principle, there is no limit to the ratio of the value of exports to GDP,³⁰ and in a few cases the ratio in practice exceeds one hundred percent because of re-exports. However, very high ratios are characteristic of very small countries, and values greater than one hundred percent are limited to city-states (e.g., Hong Kong, now a province of China). Table 9 lists the world's twenty-five most populous countries (with the exclusion of Afghanistan), and of these twenty-five only one had an export to GDP ratio above fifty percent, and only three in the forty to forty-nine percent range (Nigeria, the Philippines, and Thailand). The other statistics provided indicate that among these countries the ratio is not significantly correlated with per capita income or composition of exports.

³⁰ Note that exports represent gross production (value added plus intermediate costs), while GDP excludes intermediate costs.

If one excludes re-exports, which tend to be small in large countries, there are clear reasons why there is a practical limit to the export to GDP ratio, as suggested by the table. First, all but a small portion of public sector output, excluding state enterprises, is non-traded. In Ethiopia this is about twenty percent of GDP. Second, populous countries also tend to be large in land area, implying a relatively large transport sector, which is non-traded. Third, there are a range of goods and services which are either inherently non-traded (e.g. personal services), or non-traded due to national tastes (see Liang 1992). Fourth, large countries tend to develop diversified import replacement industries, even in the absence of an industrial policy ('protection'), which stakes a claim on resources that might be used for exports. For large countries, these four factors set a strict ceiling to the export to GDP ratio at about fifty to sixty percent. This ceiling implies for large countries that exports cannot grow faster than GDP without limit. It can be noted that for the sub-Saharan countries in the table (highlighted in bold), the highest ratio is forty-three percent, for Nigeria, whose exports are almost entirely petroleum-based.

On the basis of this discussion, our growth scenarios assume that the export to GDP ratio in Ethiopia cannot exceed fifty percent. Were the economy to approach this level, export growth would decline due to shortages of resources required to increase the production of tradeables. This constraint sets a limit to the rate at which exports can grow, or the length of time over which export growth exceeds GDP growth, or a combination of the two. In all the growth scenarios, the emphasis on export promotion is an extension of present government policy. The export rates assumed can be judged as ambitious, but feasible, given the recent success of policy in fostering non-traditional exports.

Table 9:
Export to GDP Ratio and Related Ratios for the World's 25
Most Populous Developing Countries, 2000

Country	<u>X/GDP</u>	<u>Pop</u>	PPP <u>PCY</u>	Ag RwMt/ <u>MrchXpt</u>	Fuel Xpt/ <u>MrchXpt</u>
China	22.0	1209.7	2562	1.7	3.9
India	10.9	940.8	2163	1.7	1.9
Indonesia	31.8	194.0	2634	4.8	27.0
Brazil	9.1	160.4	6307	3.9	1.2
Pakistan	16.5	124.1	1649	4.4	1.0
Bangladesh	10.7	121.3	1245	3.1	.7
Nigeria	42.8	112.9	796	.4	97.3
Mexico	24.9	91.6	7198	1.1	12.9
Vietnam	55.0	77.3	1970	na	na
Philippines	41.0	69.3	3436	1.1	1.6
Turkey	20.2	62.3	5372	1.6	1.3
Ethiopia	11.7	57.9	649	16.3	2.5
Egypt	21.8	58.8	2861	4.9	42.3
Iran	20.9	59.5	4904	.7	84.7
Thailand	46.3	58.7	5496	4.2	1.5
Korea, Rep	34.2	45.2	11261	1.2	3.1
So Africa	23.9	39.4	9940	3.5	8.0
Colombia	16.9	38.9	6585	5.5	31.2
Argentina	9.0	35.0	10672	2.9	10.9
Tanzania	15.8	30.0	456	15.9	.8
Sudan	8.9	28.3	1515	33.4	.1
Algeria	28.1	28.2	5475	.0	95.7
Kenya	30.7	27.0	971	7.0	9.0
Morocco	27.1	26.6	3138	2.5	2.4
Peru	<u>13.4</u>	<u>24.0</u>	<u>4019</u>	<u>2.9</u>	<u>6.0</u>
Average	22.4	151.8	4221.0	5.2	18.6
	55.0				

highest (Vietnam)

Notes: X/GDP, exports as percentage of GDP; Pop, population in millions; PPP PCY, per capita income measured by purchasing power parity; Ag RwMt/MrchXpt, agricultural raw material exports as percentage of merchandise exports; Fuel/MrchXpt, fuel exports as percentage of merchandise exports.

Below we have uses a simple numerical model (see Liang 1992) to examine the link between external balance, growth and external debt in Ethiopia.

Figures 1-3 present three scenarios, all of which have the same analytical structure: the rate of growth of exports, imports and GDP are linked by fixed coefficients, and the initial values are the observed values for 2001. For all the scenarios the import coefficient is two; i.e. the rate of growth of imports is twice the rate of growth of GDP. This ratio is based on recent behaviour of the economy, and discussions with Ethiopian economists in MOFED and elsewhere. It is justified as follows. First, because the economy was closed until the early 1990s, and further trade liberalization is planned by the government, one would expect that the elasticity of consumption imports with respect to growth would be greater than unity (consumption imports would grow faster than GDP). Second, because of the lack of a domestic capital goods sector (noted

above), investment would tend to be import-intensive. The combination of elastic consumption and capital imports suggests that a coefficient of two if anything may be too low. The ratio of export growth to GDP growth is 2.5 in scenario one, and 2.9 in scenarios two and three. Unlike for imports, these ratios are targets, not based on behavioral argument.

The scenarios are: 1) rapid export growth, which proves unsustainable, because even an export growth rate of fifteen percent cannot sufficiently reduce the trade gap before the export to GDP limit is reached; 2) maximizing export growth, which successfully narrows the trade gap through extraordinarily rapid export growth in the medium term, which could also be called the 'hyper export growth scenario'; and 3) declining GDP growth in the medium term that reduces the trade deficit by increasing the difference between export and import growth. Other possible scenarios can be viewed as variations on these three.

The main feature of each scenario is summarized in Table 5. The purpose of the first scenario (see Figure 1) is to demonstrate that rapid export growth, fifteen percent in this case, is not sufficient to reduce the trade deficit, given its initial value and the rate of growth of imports required to achieve the target growth rate of GDP. These two parameters imply that the difference between imports and exports increases faster than GDP, even though exports growth is faster than imports. Neither the debt service to exports ratio or the exports to GDP ratio is binding, since the deficit does not decline.

Scenario one implies that extremely rapid export growth is required to reduce the trade deficit to its sustainable value of ten percent, and this is achieved relatively quickly, in eleven time periods ('years'). Even faster export growth would shorten this period, and the X/GDP limit would be reached sooner. The lesson from this scenario is that if the target rate of GDP growth is to be achieved, the Ethiopian government must embark on what might be judged a 'hyper mercantilist' policy of maximizing export growth. Vietnam during the 1990s provides a precedent for such a strategy, when exports grew at over twenty percent per annum for several years. Achieving such a strategy would require strong interventionist export-promotion policies, combined with industrial policy to foster import replacement.

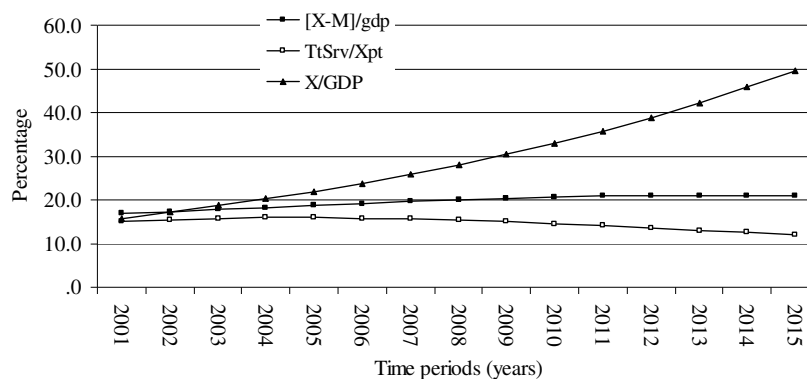
The alternative to a 'hyper mercantilist' strategy is to abandon the high growth target in the medium term. If export growth were maintained at the level in the first scenario, and the growth rate reduced asymptotically from six to four percent, the resulting fall in required import growth would achieve the sustainable trade deficit of ten percent. As before, the export to GDP limit is reached when the trade deficit achieves sustainability.

Table 5: Growth Scenarios Summarized

Scenario	Specification	Outcome	Commentary
1. Rapid export growth	GDP grw = 6% pcy growth = 3.7 xpt grw = 15 mpt grw = 12	Trade deficit stable & rises slightly until the X/GDP limit is reached after 14 time periods (years).	The scenario demonstrates that rapid export growth is not sufficient to reduce the trade gap; though $x > m$, the trade gap increases proportionately more than GDP. The debt service ratio is non-binding.
2. Maximising export growth	GDP grw = 6% pcy growth = 3.7 xpt grw = 17.5 mpt grw = 12	Trade deficit reduced to 10 percent after 11 time periods, when the X/GDP limit is reached.	The scenario demonstrates that extremely high export growth is required to reduce the trade gap to the sustainable level in a reasonable time. The debt service ratio is non-binding.
3. Slower growth	GDP grw falls exponentially from 6 to 4% pcy grw declines from 3.7 to 1.7 percent xpt grw = 15% mpt grw declines from 12 to 8%	Trade deficit reduced to 10 percent after 11 time periods, when the X/GDP limit is reached.	This scenario demonstrates the general case of achieving a sustainable trade deficit via reduction in the GDP growth rate. The debt service ratio is non-binding.

Figure 1

Key Measures of External Balance, Scenario 1
(rapid export growth)

Scenario specifications:

g = GDP growth rate = 6%

m = import growth rate = 2g

x = export growth rate = 2.5g

Initial values (actual 2001):

X/GDP = exports to GDP = 15.8%

[X-M]/GDP = trade surplus/deficit to GDP = -16.8%

TtSrv/Xpt = total long term debt service to exports = 15.0%

Key values:

X/GDP < 50%

[X-M]/GDP ≤ 10%

TtSrv/Xpt ≤ 20%

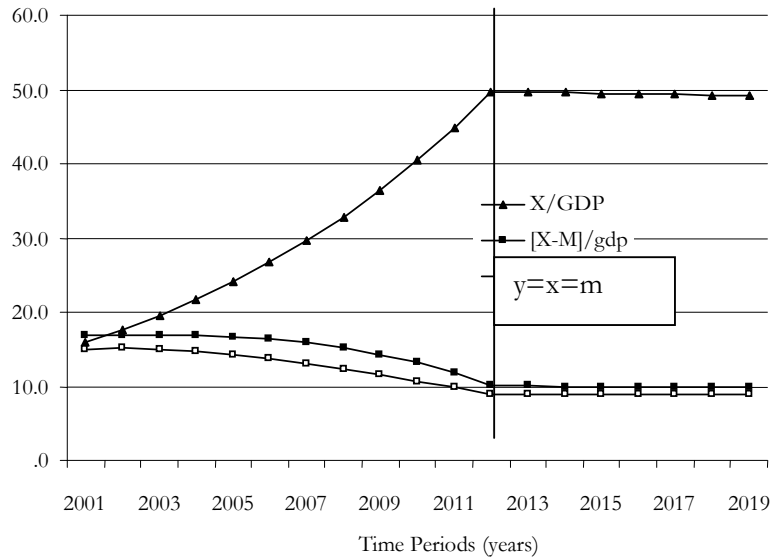
g = 6%

Commentary:

Non-sustainable scenario, because trade deficit fails to decline to maximum value of 10% before X/GDP reaches maximum value.

Figure 2:

Key Measures of the External Balance, Scenario 2
(maximising export growth)

Scenario specifications:

g = GDP growth rate = 6%

m = import growth rate = $2g$

x = export growth rate = $2.9g$

Initial values (actual 2001):

X/GDP = exports to GDP = 15.8%

[X-M]/GDP = trade surplus/deficit to GDP = -16.8%

TtSrv/Xpt = total long term debt service to exports = 15.0%

Key values:

X/GDP < 50%

[X-M]/GDP \leq 10%

TtSrv/Xpt \leq 20%

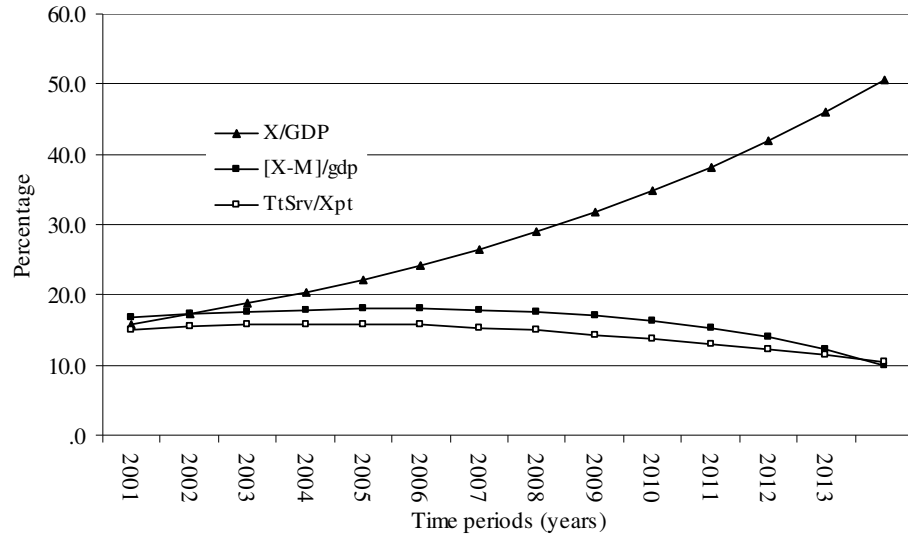
g = 6%

Commentary:

Non-sustainable scenario, because when maximum value of X/GDP is reached, imports insufficient to sustain desired rate of growth (6%).

Figure 3:

Key Measures of the External Balance, Scenario 3
(slower growth)

Scenario specifications:

g = GDP growth rate = $1/2m$, declines from 6 to 4%

m = import growth rate = declines from 12 to 8%

x = export growth rate = $2.9g$

Initial values (actual 2001):

X/GDP = exports to GDP = 15.8%

[X-M]/GDP = trade surplus/deficit to GDP = -16.8%

TtSrv/Xpt = total long term debt service to exports = 15.0%

Key values:

X/GDP < 50%

[X-M]/GDP \leq 10%

TtSrv/Xpt \leq 20%

Commentary:

Sustainable scenario for almost two decades, but rate of GDP growth below target.

Perhaps the central lesson from all three scenarios is that Ethiopia's economy cannot grow rapidly and reach a sustainable trade deficit without strongly interventionist policies. Leaving adjustment to market forces would at most result in a marginal closure of the deficit at high growth rates. This marginal improvement would be insufficient to prevent a crisis resulting from reduction of foreign exchange reserves to below import requirements. At that point, the government would have no choice but to enter into a severe stabilization programme, in which the trade deficit would be reduced through contraction of the economy, a scenario familiar to many African and Latin American countries. Non-interventionist policies, perhaps appropriate in when marginal adjustments are sufficient, are not by their nature sufficient to resolve extreme problems, which the current trade deficit is. Even were Ethiopia to enjoy a *ex machina* dramatic increase in exports resulting for example, from discovery and exploitation of major mineral or petroleum endowments, it is unlikely that the government would receive sufficient concessional aid to cover the trade deficit until these exports reached high levels.³¹

On the other hand, were strong policy measures, with export promotion and industrial policy central elements, to achieve extremely rapid export growth for the medium term, the external account would be rendered sustainable. At that point, the heavy intervention could be relaxed, which would be a practical necessity, since the economy would be close to its maximum ratio of tradables to non-tradables. A growth strategy based on increased foreign borrowing, increased remittances, and fostering foreign investment from Ethiopians abroad and international corporations, non-viable before due to the trade deficit, would become feasible. This was the experience of Vietnam, and potentially provides an exit from Ethiopia's current dilemma, and a path to sustain able rapid growth. Once out of the rapid export growth phase, government policy emphasis would shift from export incentives to investment incentives. During the phase of rapid exports, investment would be constrained by its import requirements. Once a sustainable trade gap were achieved, increasing investment would become feasible. Thus, GDP growth could increase, and the upper range of government growth targets might be feasible.

³¹ To some extent such an *ex machina* increase in exports substantially reduced Mozambique's enormous trade deficit, which was over twenty percent of GDP in the early 1990s. However, the dramatic increase in exports, of electric power to South Africa, only occurred after very large investments and with a considerable lag.

Table 6: Strategy Phases for Rapid Growth

Strategy Phases	Policy Specifications	Commentary
1. Sustained rapid growth through export-driven closure of the trade gap	Current export promotion measures extended & intensified; industrial policy to foster import replacement.	Required rate of export growth could be marginally reduced by growth of remittances. Investment promotion would be limited by import requirements. Rapid growth not consistent with rapid trade liberalisation and domestic market deregulation.
2. Sustained rapid growth, investment driven with a strong FDI component	Reducing of export incentives, and strong policy focus on investment promotion.	With a low debt service to export ratio, greater foreign borrowing would be sustainable. Rapid growth consistent with cautious trade liberalization; strong interventions necessary to foster investment growth (both FDI & domestic).
3. Sustain rapid growth, driven by a balance of export and investment expansion	Reliance on market mechanisms increasingly characterizes the policy regime.	Trade liberalization and domestic market deregulation become consistent with rapid growth.

5. Conclusions and Policy Implication

In this study an attempt is made to examine the problem of financing development. The study framed the issues under examination in a national accounting framework that helps to link the domestic resource gap (the saving-investment gap) with the external gap (export and import gap) and its external financing. The latter invariable has led to accumulation of external debt in African context and hence the need to examine the sustainability of the external sector deficit and the level of debt incurred to redress it. Having such analytical framework the study examined in details problems related to both domestic and external resource mobilization which is crucial to have a healthy internal and external balance. The former refers to the issue of domestic saving while the latter entails understanding the trade-deficit, growth and debt nexuses. The analysis is aimed at providing some indications for policy directions. The major issues addressed and their policy implications are briefly summarized below.

In the domestic arena, the level of domestic savings is far below what is necessary for sustained growth that is poverty reducing; creating a wide domestic investment-saving gap. Despite the rapid increase in bank and MFI deposits since 1992/93, the proportion of savings that is intermediated is still low, which, together with the absence of developed capital market, implies that most domestic savings are allocated directly. This in turn implies inefficient allocation as financial intermediaries and capital markets are superior in channeling resources. Besides, even the proportion that is being intermediated is not fully utilized as could be seen from the persistent excess liquidity of banks.

These problems could be addressed through a combination of various measures targeted at different sources and instruments of savings (bank/MFI deposits, pensions/provident funds, insurance, international remittance, etc.). These may include:

- Improving accessibility of existing financial instruments (e.g. accessibility of bank/MFI deposits to rural savers, T-bills and bonds to urban savers – the existing

minimum denominations of birr 5,000 and 2 billion for T-bills and bonds respectively put them beyond the reaches of individual savers);

- Increasing the range of savings instruments available; e.g. introduce government bonds of longer maturity, municipality bonds, etc. establishment of a corporate bond market; rural insurance (study on its feasibility could at least be initiated);
- Improving the returns on financial assets through tax exemptions (on contributions to pensions & life insurance and return on their investment funds), stable inflation at a rate commensurate with growth, improved alternative investment outlets for pension and insurance funds, more professional management of SSA funds, etc.;
- Legislation designed to increase pension and insurance coverage, which may include requiring private sector employers to create pension scheme for their employees and making motor, life and liability insurances compulsory;
- Establishment of a local re-insurance company; and
- Introduction of policies designed to attract international remittance and discourage their productive in non-productive activities. In view of this, some of the policies currently in place such as the privilege to Ethiopians in the Diaspora to import cars duty free and the generous grant of urban land for residential purpose may need to be reconsidered. A more rigorous and comprehensive study based on detailed data is required to inform the policy/measures to be taken in this regard.

An examination of the external finance problems of the country revealed that, thanks to the recent debt cancellation, Ethiopia's debt burden is not the binding constraint to achieve a sustainable external balance for in the short to medium term. On the contrary, the ratio of total debt service to exports in 2001, about fifteen percent, would be considered quite manageable in most countries. This should not be interpreted as implying that further debt relief is not important, for reducing debt service would free resources to apply to public investment, which in itself would increase the rate of growth. The binding constraint on the external sector is the present size of the trade deficit, which is unsustainable at almost seventeen percent of GDP, seven percentage points above ODA flows. This underscores that the debt problem is essentially a trade problem. The central policy challenge presented by the external account is how to reduce that deficit to around ten percent which is a sustainable level given country experience in the continent.

A trade deficit in Ethiopia substantially above ten percent, if not covered by sustained and predictable non-debt flows, is unlikely to be sustained in the medium term. If the trade deficit were not reduced, and covered by external loans, the result would be the repeated need for debt reduction. In other words, debt reduction alone would not create a sustainable external balance. This is a problem common to a number of African countries and to some post-central planning economies outside of Africa. In this study, using a numerical model, we considered various scenarios by which Ethiopia could move from its present stability-threatening trade deficit to one that that would be consistent with sustainable, robust growth. The key elements of these scenarios are the following:

- 1) the government's growth target of six percent or higher;
- 2) reducing the trade deficit to about ten percent of GDP;
- 3) total debt service not greater than twenty percent of exports (which proves a non-binding condition); and

- 4) a maximum feasible ratio of exports to GDP, which in African context we estimated to be about 50 percent.

After a detailed examination of various scenarios, discussed at length in the main text of this study, we arrived at the following conclusion.

From all three scenarios examined in detail we noted that Ethiopia's economy cannot grow rapidly and reach a sustainable trade deficit without strongly interventionist policies. Leaving adjustment to market forces would at most result in no more than a marginal closure of the deficit at high growth rates. This marginal improvement would be insufficient to prevent a crisis resulting from reduction of foreign exchange reserves to below import requirements. At that point, the government would have no choice but to enter into a severe stabilization programme, in which the trade deficit would be reduced through contraction of the economy, a scenario familiar to many African and Latin American countries. Non-interventionist policies, perhaps appropriate when marginal adjustments are sufficient, are not by their nature sufficient to resolve extreme problems, which the current trade deficit is. Even were Ethiopia to enjoy a *ex machina* dramatic increase in exports resulting for example, from discovery and exploitation of major mineral or petroleum endowments, it is unlikely that the government would receive sufficient concessional aid to cover the trade deficit until these exports reached high levels.

On the other hand, were strong policy measures, with export promotion and industrial policy as central elements, to achieve extremely rapid export growth for the medium term. The external account would be rendered sustainable (details of such export strategy is discussed in a separate paper on 'Concretization of ADLI'). At that point, the heavy intervention could be relaxed, which would be a practical necessity, since the economy would be close to its maximum ratio of tradables to non-tradables. A growth strategy based on increased foreign borrowing, increased remittances, and fostering foreign investment from Ethiopians abroad and international corporations, non-viable before due to the trade deficit, would become feasible. This was the experience of Vietnam, and potentially provides an exit from Ethiopia's current dilemma, and a path to sustain able rapid growth. Once out of the rapid export growth phase, government policy emphasis would shift from export incentives to investment incentives as priority. During the phase of rapid exports, investment would be constrained by its import requirements. Once a sustainable trade gap were achieved, increasing investment would become feasible. Thus, GDP growth could increase, and the upper range of government growth targets might be feasible.

In sum, rapid export growth, aggressive mobilization of domestic and external resources are the only way exit from unsustainable investment-saving gap and the severe trade imbalance which in turn is a receipt for potential external debt.

Annex

Annex 1: Number of insurance policies by type of insurance for the year 2002/03.

Insurance type	Total number of insurance policies
Aviation	11
Engineering	800
Fire	36,031
Liability	690
Marine	45,507
Motor	30,194
Accident & health	4,221
Pecuniary	21,166
Workmen's compensation	7,300
Life	103,309
Others	9,532
Total	258,761

Source: NBE

Annex 2: Gross insurance premium as % of GDP

Year	Gross premium (mil birr)	Gross premium to GDP ratio
1987/88	166.4	1.4
188/89	150.2	1.24
1989/90	136.2	1.21
1990/91	136.2	1.25
1991/92	120.9	1.14
1992/93	195.9	1.65
1993/94	246.0	2.04
1994/95	323.8	2.56
1995/96	327.9	0.86
1996/97	359.9	0.87*
1997/98	365.5	0.81
1998/99	387.2	0.79
1999/2000	439.312	0.79
2000/01	474.487	0.88
2001/02	577.557	1.10
2002/03	581.179	1.06

Source: CSA, Statistical Abstract (various years), NBE Annual Report 2001/2002, and NBE Quarterly Bulletin 4th Quarter, 2002/2003.

* It is not clear what explains the collapse in the GDP share of insurance premium starting 1995/96.

Annex 3: Insurance premium as % of GNP in Africa

Country	Insurance premium to GNP ratio
	2000
Algeria	6.54435E-06
Angola	0.027683701
Cameroon	7.50389E-06
Cote d'Ivoire	1.5378E-05
Egypt	0.014733081
Ethiopia	0.00696595
Gabon	1.00277E-05
Gambia	0.008538182
Ghana	4.45156E-06
Guinea	2.44693E-06
Kenya	2.74582E-05
Lesotho	0.160896358
Madagascar	8.53658E-06
Mali	5.72491E-06
Morocco	3.70789E-05
Nigeria	4.04337E-06
Senegal	8.76402E-06
Seychelles	0.025964046
South Africa	0.000188495
Sudan	6.5805E-06
Tanzania	1.37249E-05
Tchad	4.06573E-06
Tunisia	0.024576091
Uganda	5.50512E-06
Zambia	1.4205E-05
Zimbabwe	2.19413E-05

Annex 4: Retention of insurance premium, African countries.

Country	1993	1992	1991
Cameroon	73	67	70
Cote d'Ivoire	81	82	75
Egypt	55	55	54
Ethiopia	62	74	73
Gabon	54	55	59
Kenya	76	73	75
Libya	60	58	58
Madagascar	76	67	66
Morocco	73	73	72
Nigeria	77	66	35
Senegal	71	69	68
Seychelles	70	68	64
South Africa	94	94	94
Sudan	63	34	
Tanzania	85	84	81
Zimbabwe		79	80
Uganda		81	75
Algeria		80	77
Ghana		90	88
Chad	56	64	48
Benin		62	76

Source: Obtained from Meneyechel Enyew, BA thesis (2003), Department of Economics, AAU.

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