CREDIT POLICY, FINANCIAL INSTITUTIONS AND PRIVATE INVESTMENT IN ETHIOPIA

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1. INTRODUCTION

Financial resources are considered critical, if not the most important in economic development. This is because the pace of industrialization and economic development in Ethiopia depends on the degree of private capital participation, which in turn requires the Government's willingness and ability to provide promotional incentives and create conducive investment climate in all sectors of the economy. One of the supportive schemes that need to be considered to this end is credit or finance to alleviate the financing problems of private investors.

In Ethiopia, positive steps to improve the investment climate, particularly that of private investment, goes back to the Investment Proclamation of 1963 (SRI, 1968). Since then, several Proclamations have been issued to provide for the encouragement of capital investment in Ethiopia, depending on the political orientations of the governments. The Transitional Government of Ethiopia's (TGE) Economic Policy attaches great importance to the role and participation of the private sector in Ethiopia's economic development. To this effect, the Government has passed Investment Decrees and established Investment Offices for supporting and licensing private investors. However, decrees alone cannot be expected to bring about increased private investment unless the overall investment climate, i.e., the necessary governmental, legal, institutional, economic and social conditions under which business ventures operate, are created. In particular, conducive financial (credit) policy environment is considered to be essential. The objectives of this paper are, therefore, to

i) review the credit policies and institutional arrangements of past governments in promoting private investment,

ii)) identify the strengths and weaknesses of the past and present credit policies and financial sector arrangements in promoting private investment,

iii) assess the likely impact of the current financial sector policy measures on private investment, and

iv) suggest various policy options and institutional arrangements that would encourage and promote private investment in Ethiopia.

2. THE ROLE OF CREDIT IN PRIVATE INVESTMENT:

Increased investment of private capital both foreign and domestic, is vital to the accelerated growth of an economy. In particular, a sustainable economic development can only be achieved if it is promoted through the mobilization of domestic resources. Thus, the low level of domestic savings in Ethiopia by itself limits the extent of investment in both the agricultural and industrial sectors. Furthermore, private sector savings in Ethiopia are small and widely scattered and they are not easy to pool by formal financial institutions. Such savings are usually raised through informal savings schemes known as *Ekub* and *Edir*.

Credit system is essential in transforming savings from various sources to financial assets. The financial assets can be a stock of transferable funds that can be used by financial institutions for on-lending to the various sectors of the economy. In this manner, credit system can contribute to industrial and agricultural finance by offering better financial assets on relatively better terms and conditions to compete with other outlets of savings such as hoarding and non-productive investment. In the industrial sector, credit system facilities the transformation of financial savings into lending. As industrial development requires long-term finance, credit system contributes to the development of the industrial sector by transforming short-term financial assets into medium and long-term loans. It plays an allocative role in channelling the available funds among the various sectors of the economy.

In an economy dominated by subsistence agriculture such as Ethiopia, institutional credit serves as a real capital for needy rural people, who in turn can utilize for procuring necessary inputs to raise productivity. For the rural poor, the importance of institutional credit is vital in view of their limited capacity for savings and the exploitive nature of the informal financial markets (Sadegue,1986). Efforts to increase agricultural production largely depend upon modern cultivation practices, requiring additional doses of fertilizers, pesticides and herbicides, proper irrigation facilities and improved varieties of seeds. Most of these inputs are often not within the reach of small farmers for a number of reasons, but, primarily due to lack of capital. Unless credit is made available on sound rates and conditions, new technologies and innovations cannot be successfully introduced and adopted by small farmers.

Generally speaking, the same is true for private investors. The working capital requirements and the supplementary fund required by private investors will have to be met efficiently and on sound conditions by financial institutions. Unless their credit requirement are supplied on time delays in implementation of investment projects might arise, which may lead to cost over-runs thus reducing the profitability of investment projects. Therefore, the overall recognition of the role of credit in development by policy makers is pivotal for the creation of appropriate credit policy environment for the promotion of private investment.

3. INSTITUTIONAL ARRANGEMENTS OF THE FINANCIAL SECTOR

3.1 Pre-1974 Period

The establishment of financial institutions in Ethiopia, designed to collect and channel savings to productive investment, dates back to 1942 when the State Bank of Ethiopia was created by the Imperial Charter. The Bank combined the functions of Central and Commercial Bank until Dec. 1963 when it was split into the National Bank and Commercial Bank of Ethiopia. The central banking function was thus taken over by the National Bank of Ethiopia. The Agricultural Bank of Ethiopia, established in 1945, was targeted primarily to meet the needs of farmers who had suffered damage during the Italo-Ethiopia war. In 1949, the Bank became the Agricultural and Commercial Bank which in turn gave way to the establishment of the Development Bank of Ethiopia in 1951. The Investment Bank of Ethiopia, later known as the Investment Corporation, was founded in 1963 to perform functions broadly similar to those of the development Bank. The Addis Ababa, S.C., a private Bank with 51% Ethiopian and 49% foreign owned, came into existence in 1964. Another private Bank known as Banco di Roma (Ethiopia) was established in 1963 with a foreign participation of 49% to take over the activities of the former branches of Bank di Roma. Bank de Napoli also operated in Asmara for many years. The Development Bank and Investment Corporation merged in 1970 and formed the Agricultural and Industrial development Bank share company to deal, mainly with medium and long term loans in the agricultural and Industrial sectors, while others concentrated on short-term commercial and industrial loans. The National Resource Development Corporation, S.C. was also formed in 1966 to supersede and administer the property previously owned by the former Ministry of State Domain.

3.2 Post-Revolution Period

In the post-revolution period, financial sector institutions were nationalized and consolidated into specialized banks. At the apex of all financial institutions is the National Bank of Ethiopia (NBE), the Commercial Bank of Ethiopia (CBE), the Agricultural and Industrial Development Bank (AIDB) and the Housing and Savings Bank (HSB). The NBE, being the Central Bank of the country is responsible for issuing currency, planning and coordinating all banking activities, formulating monetary policies and acting as the financial arm of the Government. The CBE is primarily responsible for the mobilization of savings and for the extension of loans to commercial activities. The AIDB, extends, short-medium and long-term loans to the agricultural, industrial and other sectors. The Housing and Savings Bank concentrates on activities related to building including private dwellings. In addition to the banking system, the Ethiopian Insurance Corporations and the Pension Fund are organized non-banking financial institutions.

4. CREDIT POLICIES AND PRIVATE INVESTMENT

4.1 Pre-revolution Period

The National Bank of Ethiopia as the Central Bank of the country had the responsibility of licensing and supervising commercial Bank operations in Ethiopia. On the basis of the powers and responsibilities entrusted to it, the Bank set maximum interest rates on different types of deposits and the maximum deposit per savings and time deposit account at Birr 20,000. However, lending rates and sizes of loans granted by commercial banks were unregulated except, for the 12% maximum of general application. For the Commercial Bank, interest rates on savings deposits ranged between 4.5 and 6 percent, while the interest rate on time deposits ranged between 3 and 6 percent. On the other hand, lending rates ranged between 6 and 9.5% for both export and other loans. Although, the growth of savings was rapid, there was shortage of short-term funds to meet the demand for credit from commercial banks. The interest rate on all types of deposits were low to absorb sufficient funds for short- term credit. In addition, the maximum ceiling on savings deposit of Birr 20,000 was also another obstacle for the growth of deposits.

The other financial intermediaries, particularly the Agricultural and Industrial Development Bank accepted deposits, but, .on the same interest rate terms as the commercial banks. Mobilization of resources from the private sector did not yield good results, as there was no reason why depositors would prefer other financial intermediaries to the commercial bank. Furthermore, the short-term nature of these funds frustrated functions of these financial intermediaries as medium and long-term lenders. This has led the financial intermediaries to depend on government funds and foreign borrowings.

The overall credit systems during the pre-revolution period in Ethiopia were also characterized by concentration of bank operations in few urban areas. For instance, Addis Ababa alone accounted for 64% of bank branches in the pre-revolution period. In additional, the collateral requirements were up to 200% for loans by the financial intermediaries. In addition, the minimum loan requirements were high which favoured big businessmen over small ones. The agricultural sector, which received not more than 10% of total bank credit by 1974, was almost neglected. This probably reflected the adoption of the easier option to lend for less risky purposes than agriculture since there was no interest differential for assuming greater risks, and the lack of viable institutions such as cooperatives through which funds might be more easily channelled into agriculture.

Moreover, there were other factors which retarded agricultural development and rural credit in the pre-revolution period. Among the major factors were; (a) Small and fragmented land holdings that may not justify bank loans; (b) landlord-tenant relationship, in which the tenant is poor credit risk, because he was subject to the will of the land-lord and unable to provide security to receive a bank loan; (c) the communal ownership of land in some areas limited land tenure and restricted the use of land as collateral and (d) lack of clear title deeds to farmland which prevented the issuance of mortgage.

4.2 Post-revolution Period

In the post-revolution period credit has been highly regulated to ensure that the economy's financial requirements are provided for in accordance with the government's annual, medium and long-term plans. Banks' lending policies were guided by national objectives which state that "In the transitional period from a mixed economy to a socialist economic order, financial institutions will use the credit facility as factor of strengthening and expanding the socialized sector and encouraging projects, for as long as such projects are economically and social desirable, the socialized sector, will receive priority in credit allocation." To this end, priority of credit allocation was made for state owned enterprises and cooperatives. The loans and advances by sector for ten years period that is from 1981/82 to 1990/91 clearly indicates that priority has been given to public enterprises over the private sector. The loans and advances by the banking system to public enterprises, cooperatives and private individuals is depicted below.

Table 1
Loans and Advances by Sector, 1981/82-1990/91
(In Millions of Birr)

Year	Public Enterprises 1	Cooperatives 2	Private and Individual 3	Total 4	Percentage of Private as of total 3/4
1990/91	207.5	119.8	216.5	543.8	39.8
1989/90	387.5	139.7	204.3	731.5	27.9
1988/89	454.0	178.1	187.6	819.7	22.9
1987/88	517.4	169.0	205.4	891.8	23.0
1986/87	482.4	94.2	172.4	749.2	23.0
1985/86	454.4	60.2	211.1	725.7	29.1
1984/85	428.9	35.0	230.3	744.2	30.9
1983/84	877.8	53.0	362.8	1293.6	28.0
1982/83	1051.5	58.9	386.5	1496.9	25.8
1981/82	547.5	23.4	227.5	798.4	28.5
Average	545.9	93.1	240.4	879.4	27.3

Source: 1. National Bank of Ethiopia Annual Reports, 1981/82 - 1990/91.
2. Total and percentage calculated by the author.

Table 2
AIDB's Agricultural Loan Disbursals By Sector 1981/82 - 1992/93

(Millions of Birr)

Year	Public Enterprises		Cooperatives		Private		Total	
	(Birr)	%	(Birr)	%	(Birr)	%	(Birr)	%
1992/93	54,436	45.0	62,414	51.0	5,431	4.0	122,281	100
1991/92	76,370	66.0	37,235	32.0	2,185	2.0	115,790	100
1990/91	14,199	22.0	47,482	74.0	2,363	4.0	64,044	100
1989/90	133,882	61.0	83,349	38.0	2,110	1.0	219,341	100
1988/89	191,558	53.0	87,701	46.0	737	1.0	189,996	100
1987/88	239,311	7.1	78,927	24.8	287	0.1	318,525	100
1986/87	189,971	77.4	55,169	22.5	112	0.1	245,252	100
1985/86	267,197	80.1	65,726	19.7	494	0.2	333,417	100
1984/85	229,690	86.8	34,757	13.1	242	0.1	264,689	100
1983/84	222,654	91.6	20,243	8.3	306	0.1	243,203	100
1982/83	203,623	89.7	23,427	10.3	59	0.0	227,109	100
1981/82	303,581	95.0	18,087	5	18	0.0	321,636	100

Source: Agricultural and Industrial development Bank, Agricultural department

It should also be noted that the loans and advance indicated under Table 1 above include both short, medium and long-term investment loans. The loans and advance are also total disbursements by the banking system excluding government and interbank lending. Similar to the loans and advances by the banking system, disbursements by the Agricultural and Industrial Development Bank, the only financial institution entrusted with the financing of the agricultural and industrial sectors, shows that public enterprises took the lion's share of the Bank's credit in the post-revolution period. As shown under Table 2, the share of agricultural loan disbursals to the private sector was almost negligible until 1988/89 when the private sectors share become about 1 percent of the total agricultural loan disbursements. The amount and the percentage share of each sector from the agricultural loans disbursed between the period 1981/82 and 1992/93 is presented in the above table.

Industrial loan disbursements by the Agricultural and Industrial Development Bank for the period 1981/82 to 1992/93 is shown under Table 3. As compared to the agricultural credit disbursements during the same period, the share of industrial credit disbursements for the private sector seems to be relatively better. During this period the private sector's investment was only limited to small scale industries and handicrafts. As indicated in the table the share of industrial loan disbursements showed an increasing trend. Particularly, there was a substantial increase in the share of industrial loan disbursals beginning from 1989/90, probably due to the declaration of the mixed economic policy in March, 1990. Credit policies however remained the same, even after the declaration of the economic policy. Therefore, the increase in the share of the private sectors' industrial loan disbursals might be due to the relaxation of licensing and other incentives provided that might have encouraged more investors in the sector.

4.2.1 Interest Rate Policy

Apart from its central banking functions, the National Bank of Ethiopia has been responsible for planning and coordinating all banking activities and is empowered to make banking policies, issue guidelines on the allocation of credit and foreign exchange, and to set interest rates. Up to June 30, 1986 lending rates for agriculture ranged between 9 and 10.5%, while for industry it was 9.5%. There was no interest rate discrimination between public and private owned enterprises until the same date. The directive issued by the National Bank of Ethiopia under credit regulation NBE/CR/1 which became effective as of July 1, 1986, however, fixed lending interest rate for public enterprises at 6% and 8%, and 8% and 9% for private enterprises in agriculture and industry respectively. This was, therefore, a deliberate policy action to favour the public enterprises over private ones.

4.2.2 Lending Policies and Procedures of Financial Institutions

The Agricultural and Industrial Development Bank is the main source of credit for medium (2-5 years) and long-term (above 5 years) loans. The Bank extends seasonal loans for production, marketing and cattle fattening, while medium-term loans are extended for equipment, agricultural machinery, oxen purchase. Long-term loans are granted for purchase of agro-industrial machinery, land development, construction and installation of farm buildings. While cooperatives are required to at least finance 15% of the total financial requirements of the project, private individuals are required to contribute a minimum of 30% of the total project cost. Private investors are required to present rental contract/lease agreement/land holding title deeds/ for land to be used for investment with the proper license from the concerned agency. The borrower must also provide 125% of the loan as collateral if the investment is in moveable assets, while the investment itself can be mortgaged in the case of fixed assets. In the case of agricultural projects, to be located in rural areas, 125% of collateral is required in an urban area with municipality.

Projects to be financed by the Bank must be financially viable and technically sound. The repayment period of investment loans are based on their cash flow, but will not exceed 15 years. Loan approval for private loans were centralized at the head office until the end of 1992. The branch approval limit for seasonal loans has been Birr one million and Birr 300,000 for medium term loans to cooperatives. The Bank has 17 sub-branches and 12 full-fledged branches distributed all over the country.

The Commercial Bank of Ethiopia provides credit for short and medium-terms. Short-term loans are extended for a period of six months and medium-term loans between 1 and 5 years. The Commercial Bank of Ethiopia was also empowered by the Revised Rural Credit Policy No. NBE/CR/7/88, to participate in the provision of medium-term rural credit. As indicated under article 6.2.3, of the Revised Credit Policy, the medium-term credits that the Bank can grant at its sole discretion are for rural transport vehicles, such as carts and wagons, blacksmithing, village retail shops, repair and maintenance, tailoring and barbershop and rural entertainment. In financing short and medium credit the Bank requires up to 200% collateral.

The Bank's loan approval limits have been established for various categories of branches and for regional offices. In case of coffee and pulses, the branches have an individual approval limit of Birr 30,000. For cereals, the seasonal credit limit is Birr 20,000. Since there is no policy of investing a certain percentage of the mobilized resources in the same area, the Bank simply syphons out resources from the rural and transfers it to urban areas for investment.

4.2.3 Credit Regulation

In financial markets all over the world, but particularly in less developed countries, government intervention, directly or through specialized monetary and credit institutions, is the rule (Galbis, 1986). In these countries, policy interventions are found to be necessary to arrive at an optional level and structure of interest rates and an optimal generation of financial savings and allocation of financial resources. In Ethiopia also, various interest rate policies and credit regulations have been implemented by the National Bank of Ethiopia in accordance with the powers vested in it by the monetary and Banking Proclamation No. 99 of 1976. In the credit Regulation-NBE/CR/3- of the National Bank of Ethiopia which became effective as of July 1, 1986, the Supervision Authority fixed single borrower loan limit of the Commercial Bank of Ethiopia to 10% of its paid in capital and general reserve fund and Birr one million for credit requests by others. In the case of the Agricultural and Industrial Development Bank, it was limited at Birr 500,000 while in the case of the Housing and Savings Bank it was fixed at 5% of its paid in capital, general reserve fund and surplus.

Furthermore, the Commercial Bank of Ethiopia was also required to maintain on deposit with the National Bank of Ethiopia a reserve balance equivalent to 5% of its total deposits (demand, savings and time deposits). The credit regulation also become effective as of July 1, 1986. In addition, the supervisory regulation-NBE/SU/1 of NBE, required the Commercial Bank of Ethiopia to maintain liquid assets of not less than 20% of its short-term liabilities (demand, savings, time deposits payable in one year and all other liabilities payable in one year). The supervisory regulation became effective as of July 1, 1986. Even though, the credit and

Table 3
AIDB's Industrial Loan Disbursals by Sector 1981/82 - 1992/93

Year	Public Enterprises		Cooperatives		Private		Total	
	(Birr)	%	(Birr)	%	(Birr)	%	(Birr)	%
1992/93	145,682	64.2	-	-	81,257	35.8	226,939	100
1991/92	35,789	69.0	5	0.02	16,067	30.98	51,861	100
1990/91	79,011	87.0	4	0.0	12,061	13.0	91.076	100
1989/90	78,948	88.92	20	0.0	9,819	11.1	88,787	100
1988/89	111,382	95.0	53	0.0	5,424	5.0	116,859	100
1987/88	59,421	94.0	63	0.0	3,958	6.0	63,442	100
1986/87	41,041	92.0	197	0.0	3,396	8.0	44,634	100
1985/86	38,960	95.0	167	0.0	1,944	5.0	41,071	100
1984/85	39,511	94.0	192	1.0	2,233	5.0	41,936	100
1983/84	31,234	97.0	233	1.0	721	2.0	32,188	100
1982/83	26,648	94.0	198	0.0	1,612	6.0	28,458	100
1981/82	14,226	94.0	200	1.0	680	5.0	15,106	100

Source: Agricultural and Industrial Development Bank.

5. FINANCIAL SECTOR LIBERALIZATION

The financial sector in Ethiopia since the Banking Law of 1976 has been highly regulated. The sector geared to serve a centrally planned economy characterized by extensive price control, centralized decision-making and bureaucratic interference guided by socialist ideology. The rules and regulations included ceilings on credit expansion, and interest rates, restrictions on entry into the banking industry, high liquidity ratios to provide for easy financing of government deficits at low fixed interest rates. While the ceilings on interest rates resulted in highly negative real interest rates, the fixing of the rates for prolonged period of time provided little or no incentive to the accumulation of domestic financial assets. Restrictions on portfolio selection included lending to public enterprises and cooperatives at subsidized rates. These led to the holding of poor portfolios by Banking Institutions and general inefficiency in resource allocation. Under the centralized system the role of the National Bank of Ethiopia in the development of short-term and long-term money markets and financial instrument has been limited. In general, the objectives of the financial sector reform broadly include: (a) improvement in efficiency of resource allocation through greater reliance on market forces, (b) greater mobilization of domestic savings for investment and growth through market-based interest rates, (c) improvement in regulatory procedures, (d) creations of competition in the provision of banking services and (e) laying the basis for a sustainable non-inflationary or minimal inflationary growth (Omoruyi, 1991). To this end, the components of the financial sector may include reducing the extent of financing fiscal deficits, allowing interest rates to reflect market conditions and reduce credit controls, and withdraw emphasis on directed credit to socialized sector and increase the flow of credit to the private sector. In view of consideration, steps have already been taken and NBE is empowered to fix interest rates at rates deemed necessary from time to time (proclaim No. 1992). As opposed to the previous policies which provided priority to state and cooperative enterprises in the provision of loans, all sectors are now treated equally and are entertained on the basis of their viability.

5.1 Institutional Restructuring and Development

Some financial institutions in Ethiopia, like for instance, the Agricultural and Industrial Development Bank have been afflicted with a problem of insolvency. The CBE has been making profits in the last few years but has also been facing severe capital inadequacy due to the obligatory requirement to pay residual surplus to the Government. The Bank needed capital injection which should be done urgently to avoid the rapid erosion of its viability. A restructuring plan for AID Bank has already been submitted. Under the system banks and non-bank financial institutions were not independent and supervision by NBE has been directly aimed at ensuring compliance with rules and procedures. NBE has rather been manager of banks, thus being involved in directing the general credit policies of banks, interest rates, foreign exchange transactions inter-bank and bank enterprise credit transactions. Reviewing and approving loans, granted in excess of lending limits set for the banks, directing provision by banks and financial institutions on the basis of criteria favourable to the Government rather than considerations of the quality of loans have been the main areas of NBE's involvement. Therefore, the financial sector in Ethiopia has been in distress emanating from inhibitive policy environment, in-adequate prudential regulations and supervision, capital inadequacy, incidence of non-performing loans and insolvency, particularly with the Agricultural and Industrial Development Bank. The need for financial sector reform, therefore, emanated from these fundamental problems.

5.2 Financial Reform Objectives and Components

The fundamental goal of financial sector reform has been to design policies conducive to financial liberalization (Mckinnon, 1973, Shaw 1973). This implied the elimination of financial repression, that is increasing interest rates towards an efficient market clearing level, the promotion of optimal financial savings with-in a frame-work that avoids misallocation of financial and real resources (Galbis, 1988), for government decision.

In the case of the Agricultural and Industrial Development Bank the major elements of the plan are (a) writing-off the unrecoverable state farm and cooperative loans from its balance sheet, (b) providing it with autonomy in lending decisions under the direction of its board (3) recapitalizing it by converting foreign loans into capital, returning its nationalized assets and injecting fresh capital. The Council of Ministers has already deliberated on the issue and decided to transfer state farm debts to the Ministry of Finance. The Council of Representatives in the TGE has also approved the proclamation for transferring the debts to the Ministry of Finance. Decision on other issues are also being awaited and hoped to receive favourable considerations. The other element of the restructuring is the transformation of the Bank's functions into universal banking whereby it will assume all commercial banking functions.

5.3 Interest Rate Policy

Pursuant to the provisions of interest rate Proclamation No. 29/1992, lending interest rates (in percent per annum) have been effective as of October 1, 1992. The adjusted interest rates by sector are as shown below in Table 4.

The Interest Rates Directive, NBE/INT-92, also allows banks to impose additional 3% (three percent) interest on loans and advance for non-compliance of clients with terms under which the loans are extended. Loans and advance extended prior to the issuance of the directive (prior to October 1, 1992) are, however, to be governed by the provisions of their loan contracts. According to article 2.1 of the Proclamation No. 29/1992 the National Bank may from time to time fix minimum and maximum rates of interest which banks and other financial institutions may charge for different types of loans, advances and other credit transactions, and pay on various classes of deposits. The Proclamation also allowed (Article 2.2) the interest fixed by the NBE to replace the maximum rate specified by the Civil Code where the rate fixed by the banks exceed that in the Civil Code.

The new interest rates seem to be high in relation to past experience, but they are not high as compared to other countries. In fact, in light of the then galloping rate of inflation between 35 and 45% the interest rates fixed by the NBE were low. The interest rates are also low as compared with the informal sector which usually range between 50 and 300 percent. However, it is too early to make reasonable conclusion as regards the impact of the policy on private sector credit development.

Table 4
Lending Rates for Various Sectors, 1992

Sector	Short term (up 12 months)	Medium term (1-5 years)	Long term (above 5 years)
Agriculture	11.0	11.5	12.0
Housing & construction	11.0	11.5	12.0
Manufacturing industry, mining, energy, water resources, transport & comm. and export	13.0	13.5	14.0
Domestic & import trade, hotels and tourism, personal loans	14.0	14.5	15.0
Central Government	12.0	-	13.0
National Bank lending to Commercial Bank (Discount rate other financial inst.)	10.5	-	-
Other Financial Institution	10.0	-	-
Interbank lending	10	-	-

6. THE IMPACT OF DEVALUATION OF THE BIRR ON PRIVATE SECTOR CREDIT

The immediate effect of devaluation of the Birr is increased prices of imported machinery, equipment and raw materials that would be used as production inputs. The increased prices are reflected in the direct and over-head costs of production. In cases where the investment as well as the raw material inputs of a project are imported, the total cost of the project would also increase as a result of the increased investment, direct and over head production costs. The increased total project cost has two important implications for the investor. In the first place, the minimum contribution required by the financing agency will increase which means that the investor has to contribute additional amount in order to meet the minimum requirement. Secondly, as the total project cost increases, the collateral requirement will also be increased as the loan amount will be increased. On the part of the financing agency, more capital will also be needed in order to meet the normal debt equity ratio of 4:1 that would be required for a sound financial institution.

There are also other implications of the devaluation on the demand for the products produced by such projects. Because of the increase in total project cost, the prices of the project outputs might increase in order to maintain its expected project level. But, as a result of increased output prices, the demand for the commodity produced by the project might fall, thus leading to lower revenue which in effect will undermine the loan repayment capacity of the project. The financing agency's poor loan recovery due to the failure of project to service its debt may lead to illiquidity which will constrain the institution's lending capacity. At present, however, it is early to say much about its effects. But, from projects being financed by AID Bank, since the implementation of the exchange rate policy, the effects of the devaluation on the total costs of projects has become evident. As shown in Table 4 below, project costs with high imported inputs have increased significantly after the devaluation.

Table 5
Selected Project Costs Financed by AID Bank
Before and After Devaluation, 1993

Type of Project	Average Estimated Project Cost (Birr) before Devaluation	Average Estimated Project Cost (Birr) after Devaluation	Percent increase after Devaluation
Feed mill	102,973	361,201	250
Flour mill	55,062	143,240	160
Oil mill	110,000	230,000	109
Bakery & pastry	136,855	277,575	103
Cattle Fattening	215,812	246,166	15

N.B. Selected Projects are of approximately similar size.

On the other hand, projects producing exportable commodities might enjoy more benefits, as the revenue to be generated in foreign exchange will compensate for the increased costs of production. But, the problems of increased minimum contribution and collateral will remain the same at the initial stage.

7. CREDIT POLICY OPTIONS FOR PROMOTION OF PRIVATE INVESTMENT

The growth of investment by the private sector can be induced through the liberalization of the financial sector and creation of favourable economic environment. The structuring of the financial sector which has been administratively controlled for decades is particularly essential to bring about an effective reform programme that would encourage private investment. The specific Government actions required to this end are, (a) restructuring of insolvent banks, (b) effective enforcement of reserve requirements (c) elimination of interest rate ceiling (d) effective financial supervision (e) development of competitive markets for short-term securities (f) removal of barriers to entry and other restrictions on bank competition and (g) realistic exchange rate. The stimulation of competition by opening the sector to entry of new institutions would permit the reduction of monopolistic position of the few financial institutions, encourage them to reduce their cost of intermediation and improve the quality of their portfolio. It will also encourage the institutions to improve and expand the quality of their services.

While the above measures are to be taken under the framework of the financial sector reform programme, their implementation need not be at the expense of the development of key sectors that need special attention at this early stage of development. In Ethiopia, concern for the key sectors, particularly for agricultural credit and small-scale enterprises must be manifested in the set of policies to be put in place to promote their development. The credit policies and incentives that may be put in place can be classified into two, viz. credit allocation and institutional incentives. There are a number of policy instruments that are available for compelling banks to allocate credit to the key sectors. These are:

i) Credit quota and portfolio ceiling devices which require that commercial and other banks must lend a certain percentage of their loan portfolio to the key sectors,

ii) Interest rate regulation - setting lending to the key sectors at concessionary interest rates, than other sectors,

iii) Requiring commercial and other banks that certain percentage of rural savings mobilized must be ploughed back as credit to the same areas,

iv) Policies tied to the discount and guarantee mechanism by which the central bank may offer preferential rates in rediscounting papers originating in high priority sectors to provide as added incentives for the banks to increase lending to those favoured activities. An example of such mechanism would be export credit guarantee and refinance scheme,

v) Reserve requirement: This links differential requirements to the composition of commercial and other bank portfolio. Banks whose portfolio conform to the requirement of certain minimum percentages of loans to high priority areas are allowed to maintain lower liquidity ratios than normal ratios,

Similarly credit incentives and/or supportive financial facilities principally meant to induce commercial banks to provide credit to desired economic activities may need to be introduced. These may include rural banking schemes, agricultural credit guarantee schemes, crop insurance schemes and on-lending credit funds aimed at providing soft medium and long-term loans through banks to small and medium scale enterprises.

8. CONCLUSION

In the pre-revolution period there were a good number of banking and non-banking financial institutions, but, the period was characterized by shortage of funds to meet demand for credit. The interest policy as well as the maximum ceiling on savings deposits did not allow banking institution to mobilize sufficient funds to meet the growing demand for credit. The high collateral requirements by banks from borrowers and the minimum loan limits also favoured the big businessmen. In the agricultural sector, there were no viable institutions to chunnel credit to small farmers. Credit to the sector was also retarded by un-economic landholding which did not justify bank loans, unfavourable landlord-tenant relationship which made poor peasants unable to provide security to receive bank loan, the communal ownership of land and lack of little deeds for farm land. The pre-revolution period was also further characterized by concentration of banking and non-banking institutions in major urban centres only.

In the post-revolution period financial institutions were nationalized and consolidated to serve the economic policies of the centralized system guided by socialist ideology. All financial institutions were brought under direct control of the National Bank of Ethiopia which has been highly involved in the administration of financial institutions. The credit and interest rate policies were set in favour of the socialized sector. Therefore, the over- all financial policies in the post-revolution period did not encourage private investment.

However, since the declaration of the mixed economic policy in March 1990, there has been some green lights towards the encouragement of the private sector. The Transitional Government's Economic policy also emphasise the importance of the private sector and the key role that it should play in Ethiopia's economic development. To this end, the Economic Recovery and Reconstruction Programme and the Structural Adjustment Programmes are under implementation. As part of the reform programme, financial sector reform is also under process. So far financial institutions have been working along the same policies, except, the interest rate adjustment of October, 1992. However, restructuring of the financial sector has been proposed and is awaiting Government decision. The restructuring calls for autonomy and recapitalization for financial institutions, and entry for new ones to encourage competition and efficiency in resource mobilization and provision of services. Banks are also expected to have universal banking functions and to depend on domestically mobilized resources.

However, financial sector liberalization and free market forces may not be sufficient in achieving the desired objectives under Ethiopian conditions where most of the key sectors such as agriculture and industry are at low level of development and subsistence and un monetized sector dominates the economy. Therefore, Government intervention may be essential in areas of credit allocation, provision of incentives and/or supportive financing facilities.

Furthermore, all obstacles discouraging private sector credit need to be removed. In particular, the issue of land which currently cannot be mortgaged must be clear if private sector credit and investment is to be encouraged. Healthy competition among banks and adoption of new technologies and innovations in the provision of banking services will have to be encouraged. Balanced regional distribution of banking services is also crucial for domestic resources mobilization. In general, an enabling credit policy environment needs to be ensured if private sector investment is to be encouraged.

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