ETHIOPIA'S ACCESSION TO THE WTO AND THE FINANCIAL SERVICES SECTOR

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ABSTRACT

Negotiations on trade in financial services will be one of the key issues of Ethiopia's WTO accession process. This is due to both the importance of financial services for the economy at large and the nature of trade in services. Regarding the former, financial services, which include banking, insurance, securities and related services, play an important role for national development by steering the flow of resources within the economy. Conversely, the banking industry can also be a source of fragility, especially in countries where domestic economic activity is concentrated in particular industries or commodities, making it difficult to diversify risk and absorb shocks to the financial system.

The purpose of this paper is to provide an ex ante qualitative assessment of the likely consequences of potential liberalisation commitments which Ethiopia may make in its WTO accession with regard to the financial services sector. The paper provides an overview of the Ethiopian financial services sector both from an economic and regulatory perspective, including an analysis of the current degree of openness. It also briefly reviews financial sector liberalisation undertaken in other countries both within and outside the context of WTO accession.

The main findings are that compared to the status quo, improving the efficiency of the financial services sector will require a certain extent of market opening. Such opening will require, however, that a number of measures are adopted by the government and financial sector stakeholders. These relate to, first, the strengthening of domestic financial institutions in order to prepare for increased future competition. Such strengthening will require activities on two levels. At the systemic level, the financial sector infrastructure needs to be improved. This must go hand in hand with capacity building of individual financial services providers in Ethiopia. Second, perhaps even more important is the upgrading of the regulatory framework and supervision capacities.

Keywords:
WTO accession, trade in services, financial services.
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1 BACKGROUND

Negotiations on trade in financial services will be one of the key issues of the WTO accession process. This is due to both the importance of financial services for the economy at large and the nature of trade in services. Regarding the former, financial services, which include banking, insurance, securities and related services\(^1\), play an important role for national development by steering the flow of resources within the economy. Conversely, the banking industry can also be a source of fragility, especially in countries where domestic economic activity is concentrated in particular industries or commodities, making it difficult to diversify risk and absorb shocks to the financial system (Dobson 2007).

During accession negotiations, some WTO Members are likely to request Ethiopia to commit to financial services liberalisation. Financial services liberalisation generally refers to the removal of discriminatory quantitative or qualitative regulations that discriminate against foreign and domestic financial services providers by limiting market entry or commercial presence. Thus, to a significantly higher extent than trade in goods, the liberalisation of trade in services requires the amendment of domestic legal and regulatory provisions. In the context of WTO accession, policymakers in Ethiopia confront the challenge of creating a strategy to promote a vibrant domestic financial sector that is conducive to improvements in sectoral and economy-wide performance, poverty reduction and economic growth and at the same time compliant with WTO requirements (or acceptable to WTO members).

International trade in financial services can occur in different ways. The General Agreement on Trade in Services (GATS) distinguishes four so-called modes of supply. Consumers can buy financial services through "long-distance" purchase while physically remaining in their home country (called "cross-border supply" or Mode 1). Technical development notably in information and telecommunication has greatly facilitated cross-border supply of financial services, with internet banking or online purchase of insurance policies being common distribution channels these days. Alternatively, consumers can travel to and buy financial services in the country where the financial services provider is located ("consumption abroad" or Mode 2). An example of this would be an Ethiopian citizen opening a bank account abroad while being there.

The most important mode of supply for financial services is the establishment of subsidiaries or branches in the destination market (known as Mode 3 or "commercial presence"). This can occur through the establishment of new financial institutions (so-called "greenfield investment") or purchase of or investment in existing financial institutions. In developing countries, the latter is

\(^1\) Financial services are defined in the GATS annex on financial services as "any service of a financial nature offered by a financial service supplier", excluding those "services supplied in the exercise of governmental
often done in the context of privatisation programmes. Finally, trade in financial services can also take place in the form of individual persons travelling to the destination country and selling financial services there (Mode 4 or "presence of natural persons"). In financial services, Mode 4 trade usually is a consequence of commercial presence of financial institutions, i.e. managers and technical staff of the foreign investor working in the destination country. Mode 4 trade is also important in selected auxiliary services typically provided by individuals such as actuaries.

A country's GATS commitments in the financial services sector can comprise any of the four modes of supply. Furthermore, they can refer to the financial services sector at large or only certain sub-sectors or products – the GATS distinguishes two main sub-sectors, insurance and banking services, with a total of 16 service products. Last but not least, commitments can be made regarding the removal of market access restrictions for foreign services providers and regarding limitations in national treatment of such services providers.

The question of whether financial liberalisation (i.e. opening up for foreign entry) is beneficial for a country, especially developing and least developed countries, has been widely discussed and heatedly debated. While opening up may bring about economic and social benefits it also entails certain important risks. Prudence thus dictates that the benefits and risks be weighted carefully in deciding whether or not to liberalise.

On the positive side, increased domestic competition may bring about improved quality of services and a wider choice in the form of access to new services channels; faster access to services; better credit assessment procedures and information-gathering techniques; wider choice of products and vendors; and easier and more effective diversification of risk. New skills, new products and technologies may be diffused into the domestic financial system, assisting its modernisation.

Financial services liberalisation may also provide a catalyst for domestic reform by creating a constituency for improved regulation and supervision, better disclosure rules, and an improved legal and regulatory framework with greater regulatory transparency of domestic regulations and practices by making information about laws, regulations, and administrative guidelines more readily available to all market participants. The presence of foreign financial institutions may help to provide strong prudential supervision for that portion of the financial system in the host country.

Finally, the robustness of the domestic financial system to shocks may be enhanced by foreign banks that can provide for additional funding and capital if needed from their parent organisation. Access to international capital may be facilitated and the amount of saving available for productive investment augmented.

authority", which includes "activities conducted by a central bank or monetary authority or any other entity in pursuit of monetary or exchange rate policies".
On the other hand, however, liberalisation may not yield a more stable source of credit for domestic borrowers. If foreign bank entry is accompanied by reduced barriers to capital outflows, banks may use funds raised in the domestic market to undertake external lending with the consequence that domestic borrowers may not have the same degree of access to domestic savings as before liberalisation. Another risk is that foreign financial services providers might shift funds abruptly from one market to another as they perceive changes in risk-adjusted returns. They may be more likely to “cut and run” during financial crises.

Especially in the early stages of liberalisation, foreign banks may try to “cherry pick” the most desirable markets and customers, leaving the domestic banks with higher-risk assets and customers. Foreign financial institutions may only service profitable market segments. They may not give priority to issues of poverty alleviation and the access of low-income and rural-based savers and borrowers to financial services. This risk may be exacerbated if, depending on the banking structure and regulatory capacity, foreign financial service providers encourage the development of oligopolistic, rather than competitive, banking structures.

Finally, foreign financial institutions may not guarantee safety and soundness, especially if they have questionable ownership links with other international banks and are not subject to close monitoring in the host country.

It is also important to consider how financial services liberalisation may fit into a country’s overall development objectives. In Ethiopia, because of its importance for economic development, the Government has taken a cautious approach towards financial sector reform. Although liberalisation has taken place since 1992 by allowing private financial institutions to operate, the sector has remained reserved for domestic investors. In both the banking and insurance sub-sectors state-owned firms are still the most important actors – although their market shares have been shrinking – which are complemented by a number of relatively small private banks and insurance companies with relatively limited product portfolios and geographical outreach.

The purpose of this contribution is to provide an ex ante qualitative assessment of the likely consequences of potential liberalisation commitments which Ethiopia may make in its WTO accession with regard to the financial services sector. The structure of the rest of the chapter is as follows: Section 2 presents an overview of the Ethiopian financial services sector both from an economic and regulatory perspective, including an analysis of the current degree of openness. In section 3, we give a brief review of financial sector liberalisation undertaken in other countries both within and outside the context of WTO accession. This is followed by an assessment of the likely consequences of different options for financial services liberalisation which Ethiopia may undertake in the context of WTO accession in section 4. The last section concludes.
2 THE ETHIOPIAN FINANCIAL SERVICES SECTOR – AN OVERVIEW

Within the financial services sector, usually three sub-sectors are distinguished, namely banking, insurance, and securities. In Ethiopia, like in many developing countries, micro-finance constitutes a separate sub-sector of financial services. The sector is at a fairly infant stage of development. Total financial sector assets account for roughly 5% of GDP. As in most developing countries, financial services are dominated by the banking industry, which holds approximately 80% of total financial sector assets, with insurance and micro-finance sectors accounting for 10% each.

Securities do not play any notable role at present. A securities market was established in the 1960s but was closed by the Derg regime. Treasury bills are the only active primary securities used in Ethiopia, and secondary markets still do not exist. Long-term securities such as bonds are occasionally issued by the NBE to finance government expenditure and/or to absorb excess liquidity in the banking system. Some corporate bonds have also been issued recently by parastatals. A stock exchange does not exist.

The current structure of the Ethiopian financial services sector cannot be understood without a brief view on its history. Most notably, all banks and insurance companies were nationalised by the Derg regime in 1975. The then existing insurance companies were all merged into a single insurer. Likewise, only four public banks with specific sector approaches remained. It was in 1994 that the financial services sector was liberalised by allowing private domestic investment in banks and insurance companies. This has spurred the establishment of private banks and insurance companies, a process which is still going on today and continuous growth of the sector.

2.1 The Ethiopian Banking Sector

The Ethiopian banking sector today consists of eleven banks that are operational, of which three are state-owned and eight private. Five banks are in the process of establishment. In 2006/07, the private banks had 232 branches and a total paid-up capital of ETB 2.9 billion (compared to 255 branches and a paid-up capital of ETB 6.3 billion of the three public banks). Private banks thus account for about 31.5% of the total banking capital and 47.6% of the total branches. With regard to assets, although the private banks’ share has steadily grown, it still remains at about one quarter of total bank assets (23.4% in 2006 compared to 76.6% of the state-owned banks). The largest bank alone (the CBE) has more than two thirds of total banking system assets; it is thus

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2 Informal financial services, which constitute the only type of financial services to the majority of the population, are unlikely to be tapped by financial services trade (the amounts of individual deposits/loans are too small to be interesting for formal financial institutions, and clients too disperse). There are also hardly any data available on informal finance.
three times larger than all private banks combined, and more than ten times as large as the largest private bank.

The commercial banking system is complemented by a number of micro-finance institutions (MFIs) which are regulated as they are authorised to accept deposits from the public. They are however subjected to different regulatory standards as their purpose is understood to not only generate profits for the owners but also to fulfil a social objective by incorporating the (mainly rural) poor strata of the population into the banking system that would otherwise have no access to basic banking services – mainly small scale deposits and loans. At present there are 28 registered MFIs in Ethiopia with combined total assets of ETB 3.5 billion (about 3.4% of assets in the commercial banks), serving about 1.6 million clients. The assets of the largest two MFIs are comparable to those of the smallest private banks. However, most of the MFIs are considerably smaller with four MFIs alone accounting for more than 81 per cent of total capital, 86 per cent of savings, 84 per cent of credit and 84 per cent of total assets.

The banking sector has been rapidly growing. Total deposits held by Ethiopian banks more than doubled, from ETB 23.1 billion in 2001 to ETB 53.9 billion by the end of 2006/07. This corresponds to an average annual growth rate of 13.9% over the period. Relative to GDP, total deposits reached a peak of 46.6% in 2006/07. The development of private banks in deposit mobilisation was especially dynamic – their deposits increased 33.5% per year on average, compared to an annual deposit increase of 9.4% in public banks. In absolute terms, public and private banks mobilised deposits of approximately ETB 10 billion over the five year period. Despite the dynamic performance of private banks, however, the public banks still have a dominant position, holding about 70.6% of total deposits at end of June 2007.

The total value of outstanding credits of the banking sector remained almost constant until 2003 at between ETB 15-16 billion. Since then it has increased significantly, mainly as a result of a sharp increase in loan disbursements of private banks, reaching ETB 44.3 billion at end of June 2007. The market share of public banks in total outstanding loans is still higher than that of private banks although it has dropped continually, from 95% in 1998 to 67% in 2006/07.

The trade sector (domestic and international) is the most important sector for both state-owned and private banks, but more so for the private banks in terms of its share in annual loan disbursements. Among the private banks, the average share of trade finance ranged between 49% and 80% during the period 1999/00 – 2006/07. Despite its importance in the economy, the agricultural sector is marginalised by the private banks, being served predominantly (more than 90% in terms of disbursement) by the state-owned banks. Similarly, the involvement of most private banks in industrial lending is limited. Again, the state-owned banks provide most of the credit, accounting for more than 55% over the past seven years.

Interest rates on deposits, which are subject to a floor set by the NBE, stood at 6% p.a. until 2000/01, then reduced to 3% only to be raised to 4% since July 2007. Average lending rates of public banks were 10.5% until 2000/01 and 8.0% since then; private banks charge approximately
1% higher interest rates on loans. The interest spread is thus 5% for public banks and 6% for private banks. The MFI rates range from 12% to 24% p.a. in the case of lending and from 3% to 8% in the case of saving deposits.

With the exception of 2001/02, the banking system – and indeed each individual bank – has been profitable each year since 1997/98. Interest income is an important source of net total income for the banking industry as a whole (as well as for almost all individual banks) accounting for 52% on the average.

Financial services coverage in Ethiopia is far below international as well as African standards. The population-to-branch ratio in Ghana and Uganda is about 54,000 and 130,000 respectively. In South Africa and Namibia, the ratio is 11,136 and 20,074, respectively. However, average coverage has improved significantly since the opening to the private sector – the population-to-bank-branch ratio has continuously improved from 253,000 in 1995 to 158,372 in 2006/07.

The banking sector is characterised by a high urban concentration of branches. More than 52% of the total branches of all the banks are located in the eight major towns of the country (residence for only 6.6% of the total population); Addis Ababa alone accounts for 37.6% of the total branches.

The magnitude of non-performing loans (NPLs) in relation to the total outstanding loans and advances is the main performance indicator of the banking sector. Consolidated data indicate that NPLs reached a peak in 2002 (at ETB 8 billion) and have been reduced to ETB 3 billion since then. The latter corresponds to NPL-to-outstanding-loan ratios of 48.6% in June 2002 and 14.0% in June 2006; the latter is the best value over the past eight years and shows that efforts of Ethiopian banks (especially public banks) in improving their loan portfolio have been by and large successful. However, this level is still higher than in e.g. Uganda or Kenya.

Until recently, a major feature of the Ethiopian banking sector has been the accumulation of large excess liquidity among formal banks. The magnitude of excess liquid assets grew had reached over ETB 16.6 billion in 2006 with considerable variation in the liquidity ratio across banks. Excess liquidity was particularly high among the public-sector banks. The CBE in particular had large idle funds with its loan-to-deposit ratio decreasing steadily since 1999 and falling below 40% since 2004. High liquidity of public banks can partly be explained by the relatively rigid and tightened collateral-based lending practices and inefficient loan delivery systems. Nevertheless, in the moste recent past liquidity has reduced substantially so that certain banks are now even experiencing liquidity shortages.

In sum, the banking sector has shown a remarkable performance over the past ten years, with high growth rates and a proliferation of actors and services. Nevertheless, a number of weaknesses and problems remain which need to be taken into account in the context of WTO accession and the further development of the banking sector.
By international (including regional) comparison, coverage of banking services is still extremely low. The availability of banking services in rural areas remains particularly limited. Likewise, the portfolio of banking products is mainly restricted to basic services, although some of the private banks have begun to introduce new services such as debt cards and ATMs.

Although private banks have increased their market shares, the state-owned CBE remains the dominant player which is able to set prices. It is also the only bank large enough to serve large borrowers. On the other hand, the banking sector so far has focused on ‘corporate’ finance. Not only does retail lending account for only a minute fraction of total lending but most of the banks have no such service. Furthermore, credit allocation is skewed towards short-term loans at the expense of the financing for long-term projects. It is also biased towards trade finance at the expense of strategically important sectors, notably agriculture, and towards urban areas.

Real interest rates on both deposits and loans have been negative, more so with the recent rise in inflation. Besides, the banking sector, which has been characterised by excess liquidity in the past, is experiencing shortage of liquidity as of recently.

Although supervisory mechanisms are in place, the effectiveness and efficiency of NBE’s banking supervision capacity need to be strengthened.

Last but by no means least, the financial sector infrastructure is weak. The payment system is rudimentary. Professionals such as accountants, auditor or, financial analysts are in short supply, which results in lack of reliable information on the viability and reliability of financial intermediation, particularly in the area of risk management.

### 2.2 The Ethiopian Insurance Sector

At present, there are nine insurance companies in operation, of which one, the Ethiopian Insurance Corporation (EIC), is state-owned while the rest are private. Nevertheless, compared to banking, the dominance of state-owned insurance firms, as measured by capital or the number of branches, is more limited. EIC’s share is approximately 41% of the total capitalisation and 25% of the branch network, with the largest private competitors having shares of approximately 11% of capital and 12% of the branch network. In terms of total assets, the share of private insurance companies has steadily grown over the past years and reached 49% in 2006.

The Ethiopian insurance market essentially consists of non-life business. Although the share of life insurance in gross premia has grown steadily over the past ten years, it still remains at 5.4% (June 2006). Private insurers first introduced life insurance in 1999. The lower importance of life-insurance business for the private insurance industry may be explained by the long-term nature of the business (which requires a higher degree of customer confidence in the supplier), and also by the fact that only some of the private insurance companies offer life insurance.
The insurance market has increased on average by more than 10% per year since 2001. The share of private insurers in operational business (measured by premia and claims) has been slightly higher than 50% throughout the period. Non-operational income, i.e., investment activities by insurance companies, accounted for approximately 20% of total income over the period 2002 to 2005 but sharply increased to 30% in 2006.

In sum, the development of the insurance sector since 1994 in many ways resembles that of the banking sector, with the establishment of several new private insurance companies in addition to the state-owned EIC which continues to be the largest player. The range of insurance products offered is limited indicating that the sector is still at an early stage of development. Reinsurance and auxiliary services (such as actuaries) are hardly available in Ethiopia. Besides, insurance companies have limited capacities – premium setting is based on outdated methods, and there is a considerable lack of risk assessment methodologies. Capacity limitations also affect regulation of the sector with insurance supervision being largely ineffective.

Contrary to the banking sector, however, competition is stiff in the insurance industry. Private insurance companies (or at least some of them), ambitious to increase their sales volume, have been granting unfair and unjustifiable discounts to attract clients and attain their sales forecast. This aggressive pricing policy has led to an unhealthy spiral of premium cutting.

Finally, insurance companies' investment activities are heavily constrained by the restrictions that the NBE's investment proclamation imposed. This forces insurance companies to invest the majority of their funds in government securities and bank deposits at negative real interest rates. The lack of infrastructure, especially a stock market, further constrains insurance companies' investment activities.

### 2.3 Current degree of openness of the Ethiopian financial services sector

As mentioned before, commercial presence (Mode 3) is the most important type of international trade in financial services. In this respect, the Ethiopian financial services sector is currently completely closed to foreign investment: that is, the banking, insurance and microfinance sub-sectors are exclusively reserved for Ethiopian nationals.

With regard to other modes of supply, the Ethiopian financial services sector is more open. Cross-border supply of financial services (Mode 1) is permitted for selected services. In the insurance sub-sector, Ethiopian insurance companies buy reinsurance services from foreign reinsurers. Cross-border banking services exist but are limited (at least officially) to: (a) borrowing abroad by the government and some state-owned enterprises (e.g., Ethiopian Airlines) and (b) foreign borrowing by exporters (without a government guarantee of foreign exchange availability). Cross-border purchase of other financial services is not explicitly regulated.
There is no prohibition of consumption-abroad of financial services (Mode 2), as long as such purchase of services complies with foreign exchange regulations. The same is true for Mode 2 export of financial services, i.e. foreigners’ consumption of financial services while in Ethiopia.

Finally, with regard to the presence of natural persons in Ethiopia to supply financial services (Mode 4), the NBE has foreseen the possibility to authorise actuaries, loss assessors and loss adjustors already licensed abroad to provide such services in Ethiopia. In fact, in the absence of Ethiopian actuaries, Ethiopian insurance companies have been buying actuarial services from foreign (mainly Kenyan) actuaries. Furthermore, foreign professionals have been working in Ethiopia extensively as consultants in the financial sector.

### 3 FINANCIAL SECTOR LIBERALISATION – LESSONS FROM OTHER COUNTRIES

The Ethiopian financial services sector today is closed for international competition more than other countries' financial services sectors. Over the past two decades, many developing and transition countries have liberalised their financial services sectors. Acceding countries to the WTO have committed to opening up trade in financial services as part of their accession packages. Armenia, Cambodia, Kyrgyzstan, Nepal, Vanuatu and Vietnam are but some examples. Furthermore, many developing countries have embarked on various types of financial sector reform unrelated to the WTO. The experience of selected African (Kenya, Tanzania, Uganda and Zambia) and Asian countries (Nepal, Cambodia, the Philippines, Thailand and Vietnam) may be particularly relevant for Ethiopia as their background and/or transition processes are at to some extent comparable with Ethiopia.

The experience of these countries with financial sector reform shows that countries which strengthened the supervisory and regulatory framework prior to the introduction of liberalisation fared better than those that liberalised first. For example, in Zambia, Uganda and Thailand, the inadequate sequencing of reform measures had a lot to do with the disappointing results of liberalisation. In Thailand, prudential regulation was weak, and banks became over exposed to highly risky sectors, which led to the collapse of many of them. Thailand is a good example of a country that fully liberalised the financial system, including the capital account, despite poor bank regulation and supervision. In contrast, India demonstrates a cautious, phased approach to capital account liberalisation.

In almost all countries mentioned, too much of the financial system’s assets are invested in government securities, which are considered low risk (and are often relatively low return), and not enough is lent to privately held companies to grow their businesses and create jobs. This is most frequently due to the fact that lending to the private sector, especially small and medium-
sized businesses, is risky, costly, and requires collateral that borrowers simply do not have. In some countries, such as Uganda and Vietnam, the banking system is still dominated by state-owned banks that lend to state-owned enterprises.

In all countries examined, banking dominates the financial sector. Micro-finance is growing in most countries, but accounts for less than 5% of financial sector assets. An impressive exception to this generalisation is Indonesia. Insurance is also limited in terms of its contribution to financial sector assets. Capital markets are very new and under-developed in all countries with the exception of Thailand and the Philippines.

Countries that have good macroeconomic policies and/or stabilisation programs in place tend to have more success with financial sector reform. Countries that have very liberal financial sectors, such as Uganda, but poor macroeconomic policies and performance, are vulnerable to financial crises.

All countries studied allow foreign banks to participate in their financial systems, but not all allow 100% ownership of locally licensed banks and not all allow foreign banks to operate freely in foreign currencies. Foreign bank participation in most cases has led to increased competition, better intermediation (broader access to credit, lower cost of credit and a wider range of bank products and services) and to the transfer of experience and technology. In cases such as Zambia and Uganda, where this has not happened to the extent that the governments had hoped, it has been due to poor macroeconomic performance, weak policy environment, political stability, inadequate sequencing of reforms and/or corruption.

To summarise, the experience of many countries shows that if a country fully liberalises its financial services sector despite poor regulation and supervision, it will be more vulnerable to crises. Conversely, if a country uses capital controls to achieve prudential regulation, its financial system is likely to remain weak.

Based on an analysis of commitments on financial services made by other WTO accession countries the following lessons can be drawn for Ethiopia’s accession. Firstly, commitment schedules have tended to become more complex over time. This becomes evident especially when the schedules of Kyrgyzstan and Vanuatu (early accession cases) are compared to those of Cambodia and Vietnam (recent accession cases). However, there is no common policy regarding the extent of commitments in the two main sub-sectors, banking and insurance. Three of the six countries reviewed (Cambodia, Nepal & Vietnam) made stronger commitments in the insurance sector, two countries (Armenia and Kyrgyzstan) in the banking sector, and Vanuatu fully committed both sub-sectors. It should be noted that the countries that chose to liberalise the insurance sector more are the ones that, on average, made more limited commitments in financial services. One interpretation could be that these countries responded to external pressures for opening up their financial services sector by liberalizing the less important sub-sector and thereby preserving their political room of manoeuvre in the more important banking sub-sector.
When looking at the commitment made in the different modes of supply, the most limited commitments have been made regarding cross-border supply (Mode 1). All of the six countries studied scheduled farther reaching commitments in mode 3 than mode 1, i.e. supply through commercial presence was liberalised more than cross-border supply. This could be explained by the importance of transnational capital flows for mode 1 coupled with the acceding country governments’ concern about currency crises.

On the other hand, with the exception of Nepal, where the banking sector has largely been left unbound, Mode 2 (consumption abroad) has been fully liberalised by all six countries and across all 16 financial services sub-sectors. Indeed, consumption of financial services abroad is almost impossible to monitor. Therefore, offering full liberalisation of this mode might be a wise tactical move by any acceding country as it constitutes a liberalisation proposal without incurring any cost.

Regarding the presence of natural persons (mode 4) none of the countries made specific commitments for the financial services sector. In the horizontal sections, as a rule the presence of natural persons is left unbound in with a number of exceptions for the temporary presence of certain categories of business visitors. There are no vast differences between the countries: the presence of intra-corporate transferees (executive and managerial staff, specialists, technical staff) usually is allowed for an initial, renewable period of three years, the presence of other categories usually restricted to 90 days. In comparison, Vietnam attaches the strictest conditions to the presence of natural persons.

Also, market access commitments are far more limited than national treatment commitments. Regarding the latter, in mode 3 – which is the most important mode for national treatment issues – four of the six countries surveyed have eliminated all or virtually all limitations on national treatment.

Finally, it does not appear that the special treatment scheme for LDCs according to GATS Article XIX (2) has so far been applied in accession negotiations. Although it is true that commitments made by Cambodia and Nepal (which are LDCs) are amongst the most limited of the panel countries, the level of Vietnam's (which is not an LDC) commitments is comparable. On the other hand, Vanuatu's (an LDC) failed accession has often been cited as an example where WTO members have abused their bargaining power to pressurise the acceding country into excessive commitments not in line with its domestic policy.
4 ‘ESTIMATING’ THE CONSEQUENCES OF LIBERALISATION COMMITMENTS

In a series of interviews undertaken by the authors, Ethiopian financial sector stakeholders expressed a number of concerns regarding the potential risks of opening the Ethiopian financial services sector for foreign financial services providers.

Most of the concerns relate to the effects which the entry of foreign financial institutions may have on competition in the sector in Ethiopia. First, given the size of foreign financial institutions, their entry into the Ethiopian market could lead to consolidation if the foreign entrant was allowed to buy several domestic institutions and merge them. The same could happen if domestic institutions were forced to merge in response to the entry of new dominant players. Furthermore, foreign banks with more capital and more experience may take over the domestic financial sector, which is too young and inexperienced to compete (the infant industry argument).

These potential effects limiting competition may lead to skewed credit allocation towards large-scale industrial, real estate and service enterprises (including trade), i.e. into the most profitable products – the so-called "cherry picking" argument – and away from agriculture, small-scale and cottage/micro enterprises, and rural areas, which are sectors of high priority in the government's development strategy. Moreover, having access to funds from parent banks and international financial markets at lower cost, foreign banks may not be interested in mobilizing domestic savings. They may concentrate on lending mainly for trade purposes in Addis Ababa and other urban centres using foreign funds, contributing little towards the development of rural banking. There is thus the fear that outreach of the banking system may actually decline rather than expand as a result of foreign bank entry.

Finally, with regard to the effects of financial services liberalisation on the capital account, in particular short-term capital flows, foreign banks may serve as conduits for the inward and outward flow of such capital (e.g. through capital and money-market transactions; credit operations; personal capital movements; etc.) which may cause foreign exchange and/or liquidity shortages. This concern is particularly important in light of the somewhat limited regulatory capacity of the NBE.

In order to assess whether these concerns regarding the potential consequences of financial services liberalisation are likely to prove true, several liberalisation scenarios have been defined for each of the different modes of supply. Doing so is important since, as discussed below, the effects tend to differ depending on the form of entry. Data limitation and the fact that there are currently no foreign banks in the country precluded quantitative analysis of the issue.
4.1 Mode 1 – Cross-border supply of financial services to Ethiopia

In mode 1, the number of alternatives to liberalise trade is limited. A given sub-sector can either be opened for cross-border supply or not (i.e. remain “unbound”). Limitations may be introduced through phasing out of barriers over a transition period, or by restricting the group of persons allowed to engage in mode 1 transactions, e.g. by only allowing subsidiaries of foreign firms to purchase financial services from abroad. Nevertheless, for an assessment of the impact of liberalisation it is sufficient to distinguish between two options: the status quo and the removal of all restrictions of cross-border supply of financial services.

Compared to Mode 3 trade, liberalisation of cross-border trade in financial services carries more risks and fewer benefits. Given the currently still limited importance of cross-border trade in financial services in Ethiopia, the impact of these risks may be small in quantitative terms. Nevertheless, Mode 1 trade has been growing rapidly, and its share in total financial services trade might increase further given the advance of information and communication technologies. The main issues to be considered in this case are the exposure to foreign exchange risks and spillover effects of foreign capital market developments, and technology transfer.

Regarding the former, it should be noted that cross-border trade in financial services is a mode of supply that is most dependent on international capital transfers. Liberalisation of this mode is therefore difficult unless accompanied by commensurate liberalisation of the capital account. Furthermore, cross-border trade in financial services entails both opportunities and risks. On the positive side, it offers opportunities to engage in activities on international markets which allow a higher margin than the Ethiopian market. On the other hand, as both past and current financial crises have shown, it exposes a country to the risk of being affected by spillover effects from external crises. *Ex ante*, the likelihood of realising costs or losses from cross-border trade are difficult to assess. Under risk adverse considerations – and keeping in mind that a functioning financial sector is a vital ingredient for the functioning of the economy at large – a cautious approach in opening the financial services sectors appears to be advisable.

Such a cautious approach also seems adequate when looking at the relationship between cross-border trade and technology transfer. As the service provider remains in its home country, technology and knowledge transfer, which are important benefits expected from foreign entry, are limited. Cross-border trade in financial services thus has only very limited positive spill-over effects for the development of the Ethiopian economy.

Acceding countries so far have chosen cautious approaches to Mode 1 liberalisation, but there might be pressure from WTO Members for the liberalisation of cross-border trade at least in certain sub-sectors, notably transport insurance services.
4.2 Mode 2 – Consumption of financial services by Ethiopians abroad

Consumption abroad of financial services, i.e. an Ethiopian person opening a bank account or purchasing an insurance policy while being abroad is virtually impossible to observe or monitor. The whole transaction takes places outside of Ethiopia and also typically involves no or very limited transnational capital flows which would allow indirect monitoring. Likewise, the importance of mode 2 trade in financial services, and hence its potential impact on the Ethiopian financial services sector or the economy in general, is limited.

4.3 Mode 3 – Commercial presence of foreign financial services providers in Ethiopia

For the entry of foreign financial services providers into the Ethiopian market, a number of different scenarios can be distinguished. These vary from the preservation of the existing regime, in which commercial presence of foreign financial service providers is not permitted, to allowing full foreign ownership of financial service providers immediately upon WTO accession. In the following, we briefly discuss the potential impact of some of the thinkable scenarios: preservation of the status quo, entry through partial equity participation, greenfield investment, entry through branches and subsidiaries.

The main beneficiaries of the status quo scenario are the domestic financial institutions, whereas the overall effects on the economy are likely to be less positive, with the possible exception of availability of rural banking services. Besides, maintaining the current regulation, i.e., reserving financial services business to Ethiopian nationals, is likely to face challenges, as most of the existing WTO member countries are unlikely to accept the rejection of Mode 3 forms of market access and may demand access. This scenario is thus not very likely to be feasible if Ethiopia is to accede the WTO.

Entry through equity participation: Entry through equity ownership, with significant, but less than 100% share, would bring about a number of advantages and benefits in the financial services sector. It would increase the capital base of domestic financial institutions and improve their skill base and technology. It would do so without competing them out of business. The increased capital base would increase availability of finance to the economy in general. Coupled with better credit allocation mechanisms and procedures brought about by improved banking procedures and skills, such entry can be expected to contribute to increased economic growth. Furthermore, with their better methodologies to assess the creditworthiness of customers and manage risk, the entry of foreign banks (under any type of entry) should improve the mix of financial services and risk management tools in the country, thereby contributing to the overall soundness of the domestic financial system.
The benefits would be even greater if foreign banks entered into retail banking (provision of home loans, auto loans, credit cards, etc.) as well as lease financing, in addition to corporate banking. This would fill a large financing gap in the country without having a major impact on domestic banks as they are not presently operating in this market segment in any important way.

Conversely, the scenario entails some potential disadvantages and risks. First, the implications for agricultural credit and the availability of banking services in rural areas will depend on how the market shares will be affected in the most profitable market segments in particular of the institutions that are currently providing rural banking services. Second, the impact of foreign bank entry on domestic savings mobilisation depends on the degree to which they rely on foreign funds (from their parent companies or borrowed abroad) to finance their lending operations. Finally, as domestic banks would benefit from a substantial degree of protection, they might prefer to remain infants and/or rent-seeking and lobby for continuation of ceilings on foreign equity participation. There is an inverse relationship between the interest of foreign banks to buy into existing domestic banks and the ceiling on participation.

The main line of argumentation for the insurance sector is identical to that of the banking sector. Bringing in international know-how would be especially beneficial with regard to risk assessment and premium setting, and in long-term/life insurance business.

*Entry through Greenfield investment:* The likely consequences such form of entry on the Ethiopian financial services sector can be summarised as follows. Given their current state in terms of financial and human capital, technology, products, etc., domestic financial institutions would be exposed to stronger competitive pressure than under the previous scenario. Furthermore, existing domestic service providers would not benefit from the transfer of know-how and technology that would likely arise under the previous scenario, implying an increased risk of failure. The establishment of new partly foreign owned financial institutions would thus likely result in major changes in the financial services market than under the previous scenario.

An argument in favour of this form of entry is that it increases the number of financial services providers, hence, by implication, competition. In Ethiopia, the number of financial institutions is still relatively small, although constantly growing. However, the limited competition in the Ethiopian financial sector is not a result of shortage in number but the existence of dominant players (the CBE in banking and the EIC in insurance) and the lack of capacity to compete of the other institutions. Under this market structure the entry of new financial institutions (hence, the increase in the number of banks and insurance companies) does not necessarily contribute to more competition unless the new entrant is large. As a result, equity participation by foreign entrants in existing financial institutions may be more desirable as it increases the capacity to compete of existing institutions with the dominant player.

*Entry through branches:* This form of entry might bring about a number of advantages and benefits. Creditors of a branch in any country have full legal claims on the institution’s assets as a whole. Conversely, creditors of the parent institution have legal claims on any of its branch office’s
assets. In other words, branch insolvency cannot be separated from that of the parent institutions. Depositors in a branch of a foreign financial institution have the right to lay a claim on the parent institution's assets if their deposits are lost. While this may mean high security or high risk depending on the state of the parent institution, and the strength of regulation and supervision in the parent institution's home country, the fact that a parent institution takes legal responsibility for local liabilities is important. Assuming that potential entrants would come from Western industrialised countries – although this is not necessarily the case, as other African, Indian and Chinese financial institutions might also have strong business interests in Ethiopia – the Ethiopian regulator could benefit from a certain degree of "burden sharing" with the entrant's home regulator. The parent institution's commitment to protect its reputation provides additional comfort.

In the banking sub-sector, foreign bank branches typically concentrate on lending, usually through a limited number of branches. While they may induce competition in the loan market, their contribution towards expanding outreach of banking services and mobilisation of domestic savings is uncertain. However, the experience of Citibank and ABN Amro suggest that if banks want to lend locally, they have to take deposits in order to fund themselves locally. This means that they would have to create branches to mobilise and attract savings.

The presumed efficiency of foreign financial institutions, their range of products, ability to respond to customer needs, and the convenience that their global reach provides makes them attractive to exporters and importers. Domestic institutions, on the other hand, have less capacity, offer fewer services, and work through correspondent banks. Foreign bank branches may therefore be in a good position to capture a significant part of the international trade finance business. Considering the share of international trade finance in the total loan portfolios of the domestic banks, private banks in particular, the impact of competition may be significant. Domestic banks would in these circumstances be forced to adjust their lending operations to meet the competition provided by foreign bank branches. It is also possible that domestic banks may take measures to consolidate their operations through mergers and acquisitions. In the final analysis, the efficiency gains stemming from the greater competition would be reflected in lower borrowing costs and smaller interest-rate margins. There would be corresponding benefits to Ethiopian firms and households as financial intermediation would become more enhanced beyond its present role in the economy.

On the other hand, entry through branches could also bring about some disadvantages and risks. For example, there may be little room for Ethiopian regulators to protect domestic depositors. This concern may be real given the recent tendency of parent banks to prevent themselves against local liabilities emanating from their foreign branches by including so-called "ring-fencing" provisions, i.e. provisions which establish that parent banks are not required to repay obligations of foreign branches facing repayment problems in connection with war, insurrection, civil strife, government actions like exchange controls, expropriation, etc. Furthermore, if branches of foreign banks take local deposits at the same or comparable conditions with those of domestic banks, clients may prefer them over domestic banks as they are well known and
reputable. This would affect domestic banks as they would suffer from shortage of loanable funds unless they pay higher interest rates on deposits compared to foreign banks. Paying higher interest would put them at competitive disadvantage by increasing their costs.

In the insurance sub-sector, the likely impact of foreign insurance companies entering the Ethiopian market through branches is as follows: The legal argumentation as presented above for the banking sector is also valid in the insurance sector. However, with the exception of life insurance, it is hardly relevant for domestic clients of branches of foreign insurance as they would not have major deposits (or equivalents to deposits) with them. It is also unlikely that branches of foreign insurance companies would offer long-term insurance business – the market segment that is least developed in Ethiopia – as they would lack the required data. The contribution of foreign branches to extending the portfolio of services would thus be limited. At the same time, the risk that branches of foreign insurance companies would ‘cherry pick’ is high – they would focus on the most profitable services and customers. It thus appears that the only advantage of allowing foreign insurance companies to enter the Ethiopian market is that this type of entry would avoid regulatory concerns, because foreign insurance branches would be subject to supervision by their home country regulators.

*Entry of foreign institutions through subsidiaries:* This form of entry is different from entry through branches in that subsidiaries are separate entities from their parent institutions. Therefore, creditors of a subsidiary have no legal claims on the parent institution or any of its subsidiaries. There is no added safety to depositors from the parent institution or its other subsidiaries. A subsidiary’s solvency is determined by its own financial performance, and the laws of the country where it is incorporated.

While the effect of foreign entry in this form on the domestic financial industry and on financial services will be similar to that of branch entry, it brings the added concern of regulation and supervision because it is not under the regulatory purview of its home-country regulators. In practice though, this may not be an issue because the international reputation of the financial institution depends on how it operates globally, not just at home. Nonetheless, the creation of subsidiaries, with a range of new products and services that may be introduced, will require careful consideration and attention by the host-country regulators.

Comparing the various scenarios it can be concluded that none comes without disadvantages. But, some carry more benefits and/or less disadvantages/risks than others. Keeping in mind the limited regulatory capacity of the NBE and acknowledging the lack of experience in Ethiopia with foreign financial service providers, partial equity participation in domestic financial institutions appears to offer the best ratio of opportunity and risk – it limits the competitive effects of the other forms of entry while at the same time ensuring technology transfer from foreign to domestic financial institutions. As this form of entry is also more gradual than the other types it gives the regulator more time to learn and adapt.
4.4 Mode 4 – Presence of natural persons in Ethiopia to provide financial services

In banking and insurance, the presence of natural persons typically is only a consequence of Mode 3 issues. Exceptions are some auxiliary services, e.g. actuaries or financial sector consultants. But similar as in mode 2, the impact of mode 4 trade in financial services on the Ethiopian economy must be considered to be minimal.

5 CONCLUSION

Compared to the status quo, improving the efficiency of the financial services sector will require a certain extent of market opening. As is widely acknowledged, one of the main benefits of WTO accession is that it constitutes a means to credibly lock in certain reform measures. In this regard, a gradual opening of the financial services sector going hand in hand with increasing regulatory capacities could therefore be foreseen in Ethiopia's services commitments.

Such opening requires, however, that a number of measures are adopted by the government and financial sector stakeholders. These relate to, first, the strengthening of domestic financial institutions in order to prepare for increased future competition. Such strengthening will require activities on two levels. At the systemic level, the financial sector infrastructure needs to be improved. This must go hand in hand with capacity building of individual financial services providers in Ethiopia.

Perhaps even more important is the upgrading of the regulatory framework and supervision capacities. As international experience has shown that the quality of the regulatory framework – both regarding the regulations and especially their enforcement – are the key to an efficient and effective functioning of the financial service sector. At the same time, effective regulation is an immensely complex issue with which even developed countries' financial sector regulators are often overburdened, as the current financial sector crises has shown all too well. Because the opening of the Ethiopian financial services sector would introduce new products and operations it would require an upgrading of the regulatory institutions in Ethiopia. However, with the regulatory framework being weak at present, financial sector opening must be phased and go hand in hand with capacity building of and increased resources for the NBE.

In general, appropriate sequencing of reforms is essential to successful financial sector liberalisation and to overall economic reform. Achieving macroeconomic stability and strengthening financial sector regulation and supervision are thus intertwined processes, along with allowing foreign banks and non-bank financial institutions to enter Ethiopia.
The experience of other developing countries demonstrates the importance of properly sequencing reforms to the success of a country’s overall reform program. Financial reforms should be coordinated with macroeconomic and financial stability. Capital controls should be relaxed only after the financial sector reforms and trade liberalisation are in place and regulatory capacities have been strengthened. Opening of the capital account after the current account and after the currency becomes freely convertible is desirable to avoid short-term outflows and resulting pressure on the exchange rate.

Finally, there is an inverse relationship between the degree of liberalisation in a country and the level of foreign direct investment inflows. Unless there is a favourable climate to encourage entry of foreign financial institutions, fewer institutions will invest and establish operations in Ethiopia. In addition to the degree of liberalisation commitments made in the context of WTO accession, the actual entry of foreign financial institutions will depend on Ethiopia's investment climate.