

Contribution of the Banking Sector for Economic Growth, Case of Ethiopian Banks

ABIYOT ALEMU (✉ abiyot123alemu@gmail.com)

bonga university

abebe G.

wollo university

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Research Work On:

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By: Abiyot A. (MBA)

Wollo University, College of Business and Economics

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Abstract

Financial institutions, especially the banking sector plays a crucial role in models of economic growth. It is an essential component of investments; bank Profit/Loss, banks deposits, banks advances and Interest Earning have considerable effect on economic activity and long-term economic growth. The view that, strong financial sector performance has the key to economic growth was reflected in the development strategies and plans in many countries. In Ethiopia, the development of the financial sector is limited, the contribution to GDP is also very low, and most of the banks attention to is on similar services and commercial activities in the domestic banking areas rather than diversified and international banking services. After selection of the study variables the researchers were described the economic growth function of the nation using the GDP Model to show the contribution of deposits, investments, advances, profitability and interest earning on GDP. This study is important to the practitioners, policy makers, and potential researchers by providing recommendable solutions those mitigate the obstacles in banking sector and providing conducive financial and economic theories and models important for the banking institutions and other concerned parties. The general objective of this study is to evaluate the contribution of the banking sector for the growth of GDP of the nation, more specifically it evaluate or measure the contribution of deposits, investments, advances, profitability, and interest earning on GDP of the nation. The appropriate research design adopted for this study was descriptive. From the total of 19 private and public banks in Ethiopia 5 banks were purposely selected (1 public and 4 private) for this study. Secondary sources of data were used for the analysis. All secondary data were collected from the different official publications of respected banks, annual reports and National bank of Ethiopia for five years (2009-2013 GC). The collected data were analyzed with the use of the SPSS (statistical package for the social sciences) program 20v. The percentage, mean, standard deviation, coefficient of variation, correlation and multiple regressions were utilized. The finding shows that Deposit, Investment, Advances, profitability, and Interest earned by Banks have significant effect on the GDP growth of the Nation. The percentage share to GDP in the sector was increased from time to time with an average of 22%, 11%, 18%, 0.86%, and 1.2% respectively.

Key words: Deposit, Investment, Advances, Profitability, Interest, and Gross Domestic Product

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List of Acronyms

ADLI: Agricultural Development Led Industrialization

ADV: Advance guaranteed by banks

AIB: Awash International Bank

CBE: Commercial Bank of Ethiopia

CIC: Credit Information Center

DB: Dashen Bank

DEP: Deposit by banks

ERP: Economic Reform program

FDI: Foreign Direct Investment

FX: Foreign Exchange

GDP: Gross-Domestic Product

GTP: Growth and Transformation Program

IMF: International Monetary Fund

INE: Interest by banks

INV: Investment by banks

IT: Information Technology

NBE: National Bank of Ethiopia

NIB: Nib International Bank

NPL: Non-Performing Loans

OLS: Ordinary Least Square

PRF: Profitability of banks

VIF: Variance Inflation Factor

WB: Wegagen Bank

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CHAPTER ONE

INTRODUCTION

1.1 Background of the Study

It is confirmed in previous studies that a significant and strong link show between the Financial Sector of a nation and the performance of overall country economy. It is crystal clear that nations who have good financial system have a tendency to develop its economic growth more quickly. Likewise in every country Banking Sectors have been monitored by regulated authorities, In Ethiopia, National Bank of Ethiopia (NBE) reform a regulatory financial sectors are trend to be a banking sector, these sector have a twofold impact first they play fundamental role in the economy through development activities second they give resources to general public and other development organization for strengthen through lending of funds & non-fund base advances, but at the same time this sector also face incapacity due to non-performing loans and to failed in recovery of given advances.

In Ethiopia, the common resource of supplies funds and the main source of financing to support the national economic performance are commercial and development banks.. However other the non-banking financial institutes like micro financial institutions, insurance companies, also take share to meeting the financial needs of the economy, thus the factors resultant for performance of bank and economic growth are investments, bank Profit/Loss, banks deposits, banks advances and Interest Earning. The commercial banks of Ethiopia and other financial industry distinguish positive financial relationship on economic growth of Ethiopia.

According to Hussain (2004) banking system plays an important role in financial sector and accounts for higher level of the sector and demonstrated a positive relationship with economic growth of Ethiopia. Over the past decade, substantial interest focused on the link between the financial sector and economic growth. Endogenous growth theory emerged in the late 1980s and paved the way for new theories exploring the link. In addition, improved empirical methods added considerable value to subsequent studies. Many studies have investigated the impact of Banking Performance on Economy of many countries in which studies tests the determinants of Interest rate and Non -Performing Loans on economy of those countries using time series or panel data. Banking Industries were highly influence by the NPL's, and mostly these loans were

not recovered. This bad debts where highly influence the power of lending for Banking sector's and inadequate the efficiency; the substantial growth in information technology has effect the performance in the banking industry of those countries (Farooq et al., 2010).

According to Rehman (2011) empirical study on financial reforms considers in the form of inflation, savings, Bank's Deposit Schedule, Bank's Lending Schedule and own spread rate. Later problem was not investigated adequately about the performance indicators of banking industry represented in the form of Investments, Profitability of banking industry, Advances, Interest Earning. This paper will try to cover the space modestly, and find out the relationship between factors which involve directly in the productivity and performance of banking sector and enhance the economic growth of the countries.

The health of our banks and the health of our economy are inseparable. The activities of banks influence every sector of the Ethiopian economy. Furthermore, as seen through the recent Global Financial Crisis, Ethiopia's financial system is a cornerstone of the nation's economic resilience. Equally, the continued strength and profitability of Ethiopia's financial system relies on the strong long-run economic growth of the nation. (World Bank, 2012).

The banking industry plays a vital role in the Ethiopia economy. Beyond providing a range of important financial services, the banking industry is a major contributor to gross domestic product (GDP), employment and information and technology (IT) investment. Additionally, the banking industry supports the Ethiopian economy by paying millions of birr in tax and millions of birr in dividends each year.

The attitude of government towards the financial sector and economic growth has become the main policy issue. It was started with the Federal democratic Republic of Ethiopia government in the 2000s. After taking the view that the Ethiopia's economic policy is based on a 5-year Growth and Transformation Plan (GTP), which envisages improvements in infrastructure, human development and agricultural productivity through the financial sector development and public support. The large public investments (19% of GDP, third highest in the world) are largely financed domestically, including through compulsory financing by commercial banks and direct financing by the central bank. These high investment levels led to very strong domestic demand, which on its turn fuelled inflation, with consumer price inflation reaching 40% in August 2011, and increased FX demand. Furthermore, financial sector has been contributed insignificantly for

GDP of the nation. Tighter monetary policy in the form of less monetary financing, aided by lower prices for food and imported fuel, brought down the inflation to single digits in 2013 (Dumetiru, 2014).

The new economy (GTP) has been used to describe the recent evolution of the Ethiopian economy, especially to argue that the economy has reached a higher level of sustained growth with better tolerance for outbreak of inflation. It is argued that the present restructuring of the Ethiopian economy is due to high investment in infrastructure, agricultural productivity and Agricultural Development Led Industrialization (ADLI). It was even claimed, the financial institutions and markets have not in line with the policy. (Ibid, 2014).

Despite the improvements in economic performance, however, Ethiopia continues to be confronted with a number of constraints. Among the constraints are levels of savings and investment that are too low to allow self-sustained growth. This has caused a lot of concern in government and academic circles about the sustainability of the achievements so far. According to the World Bank and other sources (2008-2009), the level of domestic savings and investment is inadequate to fuel the growth needed to raise living standards and generate sufficient productive employment. The Bank notes that the major share of the additional savings and investment required must come from public sources. Consequently, the present study seeks to study the contribution of banking sectors for economic growth . Financial institutions, especially the banking sector plays a crucial role in models of economic growth. It is an essential component of investments; bank Profit/Loss, banks deposits, banks advances and Interest Earning have considerable effect on economic activity and long-term economic growth. The view that, strong financial sector performance has the key to economic growth was reflected in the development strategies and plans in many countries. While financial sector development is no longer viewed as a panacea for poor countries, it is nevertheless clear that even mildly robust growth rates can be sustained over long periods only when countries are able to give recognition for the relationship between financial sector and economic growth. (Dumetiru et.2014). Based on the determinants of financial sector and economic growth parameters, policy makers could better control the desired direction of the economic growth and development.

1.2 Statement of the Problem

Most empirical studies usually conclude development of the financial sector accelerates economic growth (e.g. Levine 1997, Thiel 2001, Wachtel 2001). A few, however, contradict this finding. In transition countries, the link between financial sector development and economic growth in transition economies seems to be ambiguous at best (e.g. Krkoska 2001, Berglöf & Roland 1995, Berglöf & Bolton 2002). They note most investment in transition countries has been financed from cash flows and foreign direct investment has substituted for domestic financing. Even in central Europe, where financial sectors tend to be better developed than in CIS countries, the banks have sometimes concentrated on granting loans to the public sector. The level of loans granted to the private sector is still considerably lower than the EU average. For these reasons, one might infer that emerging domestic financial sectors have only modestly affected economic growth in transition countries.

The relationship between the amount of credit to the private sector and economic growth is less clear. It is hardly robust and causality seems to run mostly from economic growth to credit growth. This outcome contradicts the general literature, but is in line with financial sector development in transition countries. A couple of characteristics of transition economies should be noted. First, banking crises rocked the financial sectors of many countries during the first decade of transition. Thus, large amount of credit could have led to significant drops in GDP growth. Most of the findings reflected the soft budget constraints still prevalent in many transition countries. Their existence may have encouraged private sector actors to make counterproductive investments.

Against such a background, it is clear that a large banking sector is in itself not necessarily something that promotes high economic growth and on the other hand, the size of the financial sector is not a good variable to measure the development of effectiveness in the sector in transition countries.

Strong economic growth has benefits for both the general community and for banks. To achieve economic growth two options are available: using resources ‘extensively’ (that is producing more by using more of the available resources) or ‘intensively’ (that is producing more while using the same amount of available resources). However, the key to sustainable economic growth is to use resources ‘intensively’ that are to realize productivity gains. Ethiopia’s

productivity growth performance is below that of other developed nations, provides lessons and opportunities for the development of financial sectors.

Ethiopia's ambitious public investment plan has also increased pressure on the country's fiscal and external position. In 2013, the budget deficit increased from 2.8% of GDP in 2012 to 3.3% of GDP and public debt increased from 42% in 2012 to 48% of GDP. While net transfers remained strong at 12% of GDP thank to remittances from the Ethiopian diaspora and donor assistance, the current account deficit also deteriorated, from 7.2% of GDP in 2012 to 9.8% of GDP in 2013. As FDI is moderate (2% of GDP in 2013), Ethiopia relies on debt financing to cover the shortfall. Financing has been provided mainly by official creditors; in recent years, such financing came especially from China. Besides, the critically low level of FX reserves - just under 3 months of imports - makes the country highly vulnerable to a deterioration of the current or capital account balances. External debt is mainly public (at least 95% of it). Its favorable structure, 95% is medium to long term and 76% owed to official creditors, provides some comfort, but the strong increase of the debt burden in recent years is concerning. Indeed, external debt in 2013 was 30% of GDP, twice the level of 2006. The fact that the three international rating agencies have for the first time extended a sovereign rating to Ethiopia has widened access to international markets, which might contribute to a further deterioration of the balances. In 2014, the current account deficit is forecast at 11% of GDP and the public deficit at 3.4% of GDP. All in all, the government's infrastructure plans are set to further hurt external and fiscal balances. However, still relatively low levels of both external and public debt provide some comfort. In general, the development of the financial sector in the nation is limited, the contribution to GDP is also very low, and most of the banks attention to is on similar services and commercial activities in the domestic banking areas rather than diversified and international banking services. Based on this, the researchers designed to analyze the contributions of the banking sector for the economic growth of the nation by focusing on the factors affecting the banking industry, specifically investments, bank Profit/Loss, banks deposits, banks advances and Interest Earned by banks.

1.3 Objectives of the Study

1.3.1 General Objective

The general objective of this study was to assess the contribution of the banking sector for the GDP of the country by using the variables affecting the banking industry in particular and the economic growth in general (profitability, deposit, investments, bank advances and interest earned by banks).

1.3.2 Specific Objectives of the Study

The specific objectives of the study are:

- i. To evaluate the impact of deposit on GDP.
- ii. To evaluate the impact of investments on GDP.
- iii. To measure the contribution of advances guaranteed by the bank on GDP.
- iv. To measure the impact of the profitability of banks on GDP.
- v. To evaluate the impact of Interest earned by banks on GDP.

1.4 Research Questions

The study tried to find answers for the following basic research questions:

1. What is the effect of deposit on GDP?
2. What is the role of investment on GDP?
3. What is the contribution of advances guaranteed by the bank on GDP?
4. What is the relationship between profitability of banks and the growth of GDP?
5. How the Interest earned by banks can affect the growth of GDP?

1.5 Significance of the Study

This study is important to the growth of banking sector in particular and the Economic growth in Ethiopia in general by providing recommendable solutions those mitigate the obstacles in banking sector and providing conducive financial and economic theories and models important for the banking institutions and other concerned parties because they can support the prospects of the sector in the country irrespective of the contribution of the banking sector for the economic growth. Furthermore, the results of this study can be used as a reference for further investigations by showing the important gaps those need more and deep study for academicians and researchers including students.

1.6 Scope of the Study (Delimitations)

This study is bounded to cover the important private and public banks in Ethiopia.

The subjective scope of the study was limited to analyze the banking sector contribution for the economic growth of the country. The variables addressed in this study were profitability, deposit, investments, bank advances and interest earned by banks and their effect on the GDP.

CHAPTER TWO

LITERATURE REVIEW

2.1. An Overview of Financial Sector and Economic Growth

A number of studies empirically investigated the relationship between financial sector development and economic growth (Levine 1997, Thiel 2001, Wachtel 2001, Huishin-Yu and Alan, 2006). Goldsmith's work (1969) provides the earliest evidence that development of financing accelerates economic growth. However, the measure (deposits to GDP) used for financial sector development was highly simplified and the direction of causality was never assessed. King and Levine (1993) study cross-country data for 80 countries. They measured financial sector development with four indicators: the amount of liquid liabilities divided by GDP, the importance of commercial banks in relation to central bank when allocating credit, the ratio of credit allocated to private enterprises to total domestic credit, and credit to private sector divided by GDP. After controlling for other factors affecting economic growth, King and Levine find a strong positive relation between each of the financial development indicators and economic growth. Using cross-country analysis, Levine and Zervos (1996, 1998) research the role of stock markets and the banking sector. They conclude that stock market liquidity and bank development robustly correlate with economic growth.

Rajan and Zingales (1998) strongly criticise some of the variables used for measuring financial sector development and conclusions about causality in these studies. They argue that growth of the financial sector and economic growth can be driven by a common variable such as the savings rate and that the amount of credit and size of the stock market may predict economic growth as forward-looking financial markets anticipate growth. Rajan and Zingales note enterprises reliant on external financing develop faster in countries with well-developed financial sectors. Their study supports the hypothesis that causality runs from financial development to economic growth.

2.2. Developments in Ethiopian Financial Sector

The major financial institutions operating in Ethiopia are banks, insurance companies and micro-finance institutions. The number of banks operating in the country during the fiscal year reached 19. In terms of ownership, sixteen were private commercial banks, and the remaining three state-

owned. During the fiscal year, 435 new branches were opened raising the total branch network in the country to 1,724 from 1,289 last year. As a result, bank branch to population ratio declined from 62,063.6 people to 49,826.0 in 2012/13. The significant branch expansion was undertaken by Commercial Bank of Ethiopia (CBE) (173 branches), followed by Dashen Bank (36 branches), Awash International Bank (28 branches), Abyssinia Bank (25 branches), Oromiya International Bank (24 branches), Cooperative Bank of Oromiya (23 branches) and Abay Bank (22 branches). In spite of a continuous branch expansion by public banks to mobilize deposit throughout the country, the share of public banks branch network slightly down to 50.2 percent at the end of 2012/13 from 52.4 percent last year. The number of bank branches in Addis Ababa, the capital city and major business center of the country, increased by 33.5 percent from last year, indicating the booming economic activities in the city. Following a significant capital injection by private banks mainly Awash International Bank (371 million birr), Wegagen Bank (301 million birr), Bank of Abyssinia (218 million birr), Nib International Bank and Cooperative Bank of Oromiya (211 million birr) each and United Bank (166 million birr) the total capital of the banking industry increased by 28.1 percent and reached Birr 23.0 billion by the end of June 2013. Nevertheless the shares of private banks from the total capital fall to 47.8 percent from 49.3 percent the same period last year reflecting the surge in capital expansion of public banks mainly Commercial Bank of Ethiopia (2.8 billion birr). Accordingly, the share of CBE from the total capital of banking sector went up to 39.1 percent from 34.6 percent a year ago. Despite the continuous increase in the capital base, the banking industry in Ethiopia is still very small compared to some big banks in Africa, depicting the ongoing effort needed to bring Ethiopian banks to the international level. In the meantime, the number of insurance companies in the country increased to 16 from 15 in the last year. The number of branches reached 275 following the opening of 32 additional branches. Major expansion of branches was undertaken by Lion Insurance company S.C. (5 branches) followed by Ethio- Life Insurance company S.C. and Abay Insurance Company S.C (4 branches) each, Nile Insurance Company S.C and Nyala Insurance Company .S.C (3 branches) each. In terms of placement, 53.8 percent of insurance branches were located in the capital city reflecting high concentration of the business in Addis Ababa. Ownership wise,

private insurance companies owned 82.5 percent of the total branches, slightly up from 81.1 percent a year ago. On the other hand, the total capital of insurance companies increased by 24.1 percent reaching Birr 1.5 billion from Birr 1.2 billion the same period last year. Private insurance companies accounted for 74.7 percent of the total capital while one public insurance company alone accounted for 25.3 percent (NBE, 2013/14).

2.3. Overview of the Banking System in Ethiopia

According to Gebeyehu Ayichile as cited in Habtamu (2012) Traditional financial system in Ethiopia has long history and paramount contribution to economic betterment and social wellbeing of the society. Traditional institutions organized with a sense of cooperation and risk sharing has enabled Ethiopians to experience saving and financial management within its cultural context. Eqqub and Edir are some of the informal financial institutions that shaped the social bond and interaction.

Modern banking in Ethiopia was introduced after the agreement that was reached in 1905 between Emperor Minilik II and Mr.Ma Gillivray, representative of the British owned National Bank of Egypt. Following the agreement, the first bank called Bank of Abyssinia was inaugurated in Feb.16, 1906 by the Emperor. Within the first fifteen years of its operation, Bank of Abyssinia opened branches in different areas of the country in Harar (Eastern Ethiopia), Dire Dawa, Dessie and Djibouti. By 1931 Bank of Abyssinia legally replaced by Bank of Ethiopia shortly after Emperor Haile Selassie came to power. The new Bank, Bank of Ethiopia, was a purely Ethiopian institution, was the first indigenous bank in Africa, and established by an official decree on August 29, 1931 with capital of £750,000. In 1941, another foreign bank, Barclays Bank, came to Ethiopia with the British troops and organized banking services in Addis Ababa, until its withdrawal in 1943. Then on 15 April 1943, the State Bank of Ethiopia commenced full operation after 8 months of preparatory activities. In 1945 and 1949, the Bank was granted the sole right of issuing currency and deal in foreign currency. The Bank also functioned as the principal commercial bank in the country and engaged in all commercial banking activities. The National Bank of Ethiopia with more power and duties started its operation in January 1964. Following the incorporation as a share company on December 16, 1963 as per proclamation No.207/1955 of October 1963, Commercial Bank of Ethiopia took over the commercial banking activities of the former State Bank of Ethiopia. It started operation on January 1, 1964 with a

capital of Eth. Birr 20 million. In the new Commercial Bank of Ethiopia, in contrast with the former State Bank of Ethiopia, all employees were Ethiopians.

There were two other banks in operation namely Banco di Roma S. and Banko di Napoli S.C. that later reapplied for license according to the new proclamation each having a paid up capital of Eth. Birr 2 million. The first privately owned bank, Addis Ababa Bank Share Company, was established on Ethiopians initiative and started operation in 1964 with a capital of 2 million in association with National and Grindlay Bank, London which had 40 percent of the total share. In 1968, the original capital of the Bank rose to 5.0 million and until it ceased operation, it had 300 staff at 26 branches.

Following the declaration of socialism in 1974, the government extended its control over the whole economy and nationalized all large corporations. Organizational setups were taken in order to create stronger institutions by merging those that perform similar functions. Accordingly, the three private owned banks, Addis Ababa Bank, Banco di Roma and Banco di Napoli Merged in 1976 to form the second largest Bank in Ethiopia called Addis Bank with a capital of Eth. birr 20 million and had a staff of 480 and 34 branches. Then Addis Bank and Commercial Bank of Ethiopia S.C were merged by proclamation No.184 of August 2, 1980 to form the sole commercial bank in the country until the establishment of private commercial banks in 1994.

The Savings and Mortgage Corporation S.C. and Imperial Saving and Home Ownership Public Association were also merged to form the Housing and Saving 12 Bank with working capital of Birr 6.0 million and all rights, privileges, assets and liabilities were transferred by proclamation No.60, 1975 to the new bank. The financial sector that the socialist oriented government left behind constituted only three banks and each enjoying monopoly in its respective market, the following was the structure of the sector at the end of the era: the National Bank of Ethiopia (NBE), the Commercial Bank of Ethiopia, and Agricultural and Industrial Development Bank. Following the demise of the Dergue regime in 1991 that ruled the country for 17 years under the rule of command economy, the Ethiopian People's Revolutionary Democratic Front declared a liberal economy system. In line with this, Monetary and Banking proclamation of 1994 established the national bank of Ethiopia as a judicial entity, separated from the government and outlined its main function. Monetary and Banking proclamation No.83/1994 and the Licensing

and Supervision of Banking Business No.84/1994 laid down the legal basis for investment in the banking sector. In 2014, the total number of Banks get license from the national bank of Ethiopia were reached 19. (Ibid).

Table 2.3.1 List of banks in Ethiopia (2013/14)

N O	Name of the Bank	Web Site	Year Est.	No of Branches	SWIFT	Profit in ETB (2013/14)
1	Abay Bank S.C.	http://www.abaybank.com.et/	2010	79	ABAYETAA	75,000,000.00
2	Addis International Bank	http://www.addisbanksc.com/	2011	18	ABSCETAA	60,000,000.00
3	Awash International Bank	http://www.awashbank.com/	1994	191	AWINETAA	861,000,000.00
4	Bank of Abyssinia	http://www.bankofabyssinia.com/	1996	111	ABYSETAA	351,300,000.00
5	Berhan International Bank	http://berhanbanksc.com/	2010	46	BERHETAA	131,000,000.00
6	Bunna International Bank	http://www.bunnabanksc.com/	2009	72	BUNAETAA	109,000,000.00
7	Commercial Bank of Ethiopia	http://www.combanketh.et/	1963	909	CBETETAA	9,700,000,000.00
8	Construction and Business Bank	http://www.cbb.com.et/Index.html	1983	106	COUJETAA	110,000,000.00
9	Cooperative Bank of Oromia	http://www.coopbankoromia.com.et/	2005	144	CBORETAA	485,000,000.00
10	Dashen Bank	http://www.dashenbanksc.com	2003	146	DASHETAA	928,000,000.00
11	Debub Global Bank	http://www.debubglobalbank.com/	2012	32	DEGAETAA	19,000,000.00
12	Development Bank of Ethiopia	http://www.dbe.com.et/home/	1909	43	BEETETAA	491,000,000.00
13	Enat Bank	http://www.enatbanksc.com/	2013	7	ENATETAA	39,000,000.00
14	Lion International Bank	http://www.anbesabank.com/	2006	67	LIBSETAA	128,000,000.00
15	Nib International Bank	http://www.nibbank-et.com/index.php	1999	98	NIBIETTA	420,000,000.80
16	Oromia International Bank	http://www.oroointbank.com/	2008	115	ORIRETAA	205,000,000.40
17	United Bank	http://www.unitedbank.com.et/	1998	108	UNTDETAA	350,000,000.00
18	Wegagaen Bank	http://www.wegagenbanksc.com/	1997	98	WEGAETAA	394,000,000.30
19	Zemen Bank	http://www.zemenbank.com/	2009	1	ZEMEETAA	131,000,000.00
	Total			2357		14,425,000,000.00

Source: Banks annual report, www.nbe.gov.et

2.4. Deposit and Economic Growth

According to Tuuli Koivu (2002), there were a two-way causal relationship between growth and financial development. In their model, the lack of a financial sector means that every investor must individually monitor projects, so that the costs of monitoring are excessive. With a well developed financial sector, monitoring tasks are delegated to intermediaries. Transaction costs are reduced and more savings can be allotted to investments that produce new technology. Ultimately, this promotes economic growth.

Blackburn and Hung (1996) as cited in Tuuli, 2002 also show how a country might become trapped in a vicious cycle of sluggish economic growth and weak financial development. This situation occurs when the initial level of technical development in the country is very low and the expected flow of new technology remains low. Monitoring costs remain so high that financial intermediation is never organized. As a result, transaction costs remain high and economic growth remains low.

Harrison et al (1999) as cited in Tuuli, (2002) construct a model in which causality runs both ways between economic growth and financial sector development. Basically, they argue, economic growth increases banking activity and profits, which promotes the entry of more banks. The greater availability of banking services reduces the non-physical and physical distance between banks and client, which, in turn, lowers transaction costs. Endogenous growth theory argues that a higher savings rate leads to higher economic growth.

Generally speaking, development of financial sector affects the savings rate in three ways. First, financial markets can reduce idiosyncratic risks and thus lower the level of precautionary saving by households and slow down growth (Tsuru, 2000). Second, a reduction in rate-of-return risks by portfolio diversification has ambiguous effects on saving (Tsuru, 2000). Third, lowering liquidity constraints in the financial sector may lower the savings rate. For example, Jappelli and Pagano (1994) as cited in Tuuli, 2002 develop a model in which the younger generation borrows extensively when no liquidity constraints accompany the liberalization of consumer credit and mortgage markets.

Deposit and lending rates are unavailable for identical periods for each country. The overall size of the margin, however, should not be affected significantly by lending/deposit periods. Moreover, the differences in margins between and within countries are large, so a small error in

the margins should not disturb the results. The IMF has reported lending and deposit rates, but this information is not available for all transition countries. Using the IMF data where possible, the results correspond to the EBRD data. (Tuuli, 2002)

2.5. Investment by Banks and Economic Growth

According to Tuuli Koivu (2002), Both theoretical and empirical evidence suggest a strong financial sector promotes economic growth. again in his study reviewed that Seven decades ago, Schumpeter (1934) stressed the role of the banking sector as a financier of productive investments and thus as an accelerator of economic growth. Most of the theoretical models relevant to our discussion, however, followed the emergence of endogenous growth theory. Pagano (1993) suggests three ways in which the development of financial sector might affect economic growth under the basic endogenous growth model. First, it can increase the productivity of investments. Second, an efficient financial sector reduces transaction costs and thus increases the share of savings channelled into productive investments. Third, financial sector development can either promote or decline savings. Greenwood and Jovanovic (1990), Levine (1991), Bencivenga and Smith (1991) and Saint-Paul (1992) have all constructed theoretical models wherein efficient financial markets improve the quality of investments and enhance economic growth. In the Greenwood and Jovanovic model (1990), the primary task of financial intermediaries is to channel funds to the most profitable investments they can identify by using information that they have gathered and analysed. The higher rate of return earned on capital promotes economic growth, which, in turn, provides the means to implement costly financial structures. An efficient financial sector also improves the liquidity of investments. In the models of Levine (1991) and Bencivenga and Smith (1991), financial markets improve firm efficiency by eliminating the premature liquidation of firm capital. During liquidity shocks, investors can sell their shares to another agent. Financial markets may also promote growth by increasing the proportion of resources allocated to firms. Through the diversification of productivity risk, even risk-averse investors can invest in firms.

The study of Leahy and others as cited in Tuuli 2002 showed a positive and generally significant relationship between financial development ant the level of investment. When added to result that investment contributes directly to economic activity and growth (Bassanini et al. 2001), the authors see financial development as having a role in the growth process. Drakos's study (2002)

about the relation between the financial sector and economic development in 21 transition economies shows that imperfect competition in banking sectors tends to lower economic growth and deepen business cycles. Rousseau and Wachtel (2002) examine the effect of inflation on the finance-growth nexus. They argue information about investment projects becomes more uncertain in an inflationary environment, which complicates financial intermediation. High inflation may also repress financial intermediation by eroding the usefulness of money assets. Their empirical research shows that when inflation exceeds the 15-25% range, financial deepening no longer adds to economic growth. Their results are relevant for transition countries, where inflation rates were often extremely high in the beginning of the transition process.

According to Tuuli et al, (2002) the findings of numerous cross-country studies showed that financial development accelerates economic growth are somewhat contradicted by time-series models. Not only the method, but also the composition of data seems to have affected the results. Papers that use large bodies of data from both rich and poor countries normally find a causal relationship running from financial market development to economic growth. Studies of smaller groups of relatively homogenous countries often show quite opposite results. These differing results may be explained by the fact that most studies use the size of the financial sector as a measure of development in the sector. Size, however, does not necessarily capture the effect of financial sector efficiency on economic growth. Thus, the positive growth-finance nexus is only found when the size of the financial sector correlates with the efficiency of the sector. For data covering both high and low-income countries, it is typical that high-income countries have larger and more efficient financial sectors than low- or middle-income countries. In this case, the size of the financial sector correlates with efficiency and levels of income. If one studies countries with similar income levels, the size of the sector itself tells nothing about differences in qualitative levels between countries. The efficiency of the sector is thus ignored and only size is measured. These studies do not find causality running from the financial sector to economic growth and the size of the financial sector does not seem to affect economic growth. Here, we attempt to avoid this problem using variables that measure both qualitative and quantitative financial sector development.

2.6. Advances and Economic Growth

Loan is a type of debt. Like all debt instruments, a loan entails the redistribution of financial assets over time between lender and the borrower (Habtamu , 2012). According to access capital research (2011) as cited in Habtamu (2012), lending by Ethiopia's private banks is coming to a virtual standstill. They found that the average private bank has recently been giving out just 30 million birr in loans per month, or almost half the peak lending volume seen in recent years. Lending patterns continue to vary widely among banks reflecting their strategic preferences as well as varying degrees of success in entering particular business segments. One of the major functions of any commercial bank is providing loan to the business society. Lending is the provision of resources (granting loan) by one party to another. The second party doesn't reimburse the first party immediately there by generating a debt, and instead arranges either to repay or return those resources at a later date. Banks function as financial intermediaries, collecting funds from savers in the form of deposit and then supplying to borrowers as loans. Those functions benefit both the banks and the borrowers.

As quoted from Zewdu (2010), cited in Habtamu (2012) the principal profit- making activity of commercial banks is making loans to its customers. Lending represents the heart of the industry. Loan is a major asset, income source for banks, and risky area of the industry. Moreover, its contribution to the growth of any country is very clear. Therefore, managing loan in a proper way not only has positive effect on the banks profitability but also on the borrower firms and a country as a whole. The heart of any successful commercial lending function is credit discipline written in loan policy, structured loan approval process and strong loan administration function (Barrickman 1990).

According to Kayode et. al (2010) cited in Aurangzeb (2012) the effect of bank lending and economic growth on the manufacturing output in Nigeria was investigated By using the times series data which covering a period of 36 years (1973 to 2009). The empirical outcomes of the study show that production volume utilize in manufacturing and bank rate of lending loans significantly affect manufacturing output in Nigeria. However, at the other hand relationship between manufacturing output and economic growth could not be successfully made and progress in the country. Hence the results shown that a mix consideration of monitory policy for central bank to ceiling off the borrowing rate effort by the government, for the manufacturers and

the other development financial institution for revised the lending and growth regulations and provide competitive environment, in order to motivate investments to this sectors and made easy procedures for borrowing loans and advances from these institutions.

According to Samolyk (1992) cited in Aurangzeb (2012) empirically investigates the relation in the bank performance and economic growth at the state level. In their study they develop a review for regional credit that explain, one of the reason which is data cost effects the banking sectors and can also influences economic performance by development ability to funds local investments. Further the model supports that government banking sectors facing problems of economic criteria where by not well financially sound, and same that no evidence need to link in the sector which is financial established. The data has been used to find relation of this credit analysis model for the period of 1983 to 1990 the data consists of regional level and find the output of such channels which particularly, local focus on government banking sectors, further the results explain the real individual income growth in the country in consideration with NPL's which is out of the average share.

The amount of bank credit allocated to the private sector apparently does not speed up economic growth in transition countries. Its lagged value is even negatively related to economic growth and the causality between the growth of credit and real GDP growth is unclear. This result contradicts many earlier results and probably reflects the characteristics typical to transition economies, where the growth of domestic credit was often unsustainable. The results suggest two reasons that financial sector efficiency should not be measured by sector size in the case transition economies. First, the soft budget constraints prevalent in many transition countries and credit to enterprises applying soft budget constraints may lead to considerable losses in the economy when investments turn out to be counterproductive. Second, the negative link between the lagged amount of credit and growth may reflect banking crises that many transition economies experienced during the research period. The increase in credit imposed considerable costs in the wake of the crises in many banking sectors. Thus, the amount of credit is probably not a valid measure of financial sector development in transition countries. Apparently, when the financial sector or the business environment is not ready for growth in the amount of finance, growth in the amount of finance may be unsustainable and do nothing to accelerate economic growth. In the worst case, such growth in the amount of available finance may precipitate

financial crises and harm economic development. On the other hand, our results are in line with the theoretical models that indicate qualitative financial sector development accelerates economic growth. Nevertheless, it would be valuable to test empirically the channels through which financial development affects economic growth. Under the theoretical models we presented, these channels might be growth in investments, productivity improvement or an increase in the savings rate. It would also be useful to clarify the relationship between FDI and domestic debt. According to Krkoska (2001), FDI in transition countries supplements inadequate domestic resources in financing ownership change and capital formation. One might ask if this is an efficient means of finance or whether an efficient domestic financial market might be more conducive to economic growth.

2.7. Profitability of Banks and Economic Growth

Different empirical evidences suggested that profitability of financial institutions specifically banks are affected by internal and external factors. Andreas and Gabrielle (2009) as cited by Habtamu Negusse (2012) stated that Bank profitability is usually measured by the return on average assets and is expressed as a function of internal and external determinants. The internal determinants include bank-specific variables. The external variables reflect environmental variables that are expect to affect the profitability of banks. Internal factors such as capital adequacy ratio, asset size, asset quality, net-worth, liquidity, earnings quality, loan performance, business risk, management quality, people, technology and operating environment are major determinant that are used to analyzed the determinants of bank profitability. An external macroeconomic and industry-specific factor includes Effective tax rate, Real GDP growth, inflation, regulation and Bank concentration.

2.7.1. Internal Determinants of Profitability

Internal factors such as capital adequacy ratio, asset size, asset quality, net-worth, liquidity, earnings quality, loan performance, business risk, management quality, people, technology and operating environment are major determinant that are used to analyze the determinants of bank profitability discussed as follows:

2.7.1.1 Capital Adequacy

Capital adequacy is a measure of a bank's financial strength, in terms of its ability to withstand operational and abnormal losses. Further considering the regulatory requirement on the minimum capital required to be maintained by banks, capital adequacy also indicates the ability of bank to undertake additional business. Indranarain (2009), Imad et al. (2011) and Berger (1995) stated that banks with high capital ratio tend to earn more profit through translating the safety advantage into profit. The size of capital provides financial flexibility for bank and financial institution. It identifies which financing options are available for the entity. The size of capital also influences the profitability of the bank in terms of return on assets, return on capital employed and return on share holders' fund considering the funding mix (Financial Management and Analysis of Projects, 2006).

According to Abebaw and Depaack (2011), cited in Habtamu (2012) capital strength have a positive and dominant influence on profitability of commercial banks in Ethiopia. A bank should have adequate capital to support its risk assets in accordance with the risk-weighted capital ratio framework.

2.7.1.2 Asset Quality

The asset quality is measure an ability to manage credit risk for a bank or financial institution. The asset quality reflects the composition and productivity of the assets. Thus, asset quality has a direct impact on the profitability of a bank. As per Yuqi (2006), cited in Habtamu (2012) in terms of risk poor asset quality is the major cause for banks poor profitability. It is evaluated by understanding the performance of assets category wise and estimating future performance factoring in the likely distribution of the assets in future. The bank's experience of loan loss, provisions/ write off, loan recovery rate, ability to reduce nonperforming assets and extent of weak assets are analyzed in this regard (Ibid).

Many empirical evidences stated that asset quality has direct impact on the profitability of banks. The quality of assets particularly, loan assets and investments, would depend largely on the risk management system of the bank. The value of loan assets would depend on the realizable value of the collateral while investment assets would depend on the market value. According to Abebaw and Depaack (2011), cited in Habtamu (2012) used ratio of Non-performing assets (loans) to total loans and advances (NPL) as an indicator of banks' asset quality. They stated that

the amount of nonperforming assets has a direct implication in the profitability of the bank, that is if the proportion of the non performing assets in relation to total loans increase the profitability will be decreased and vice versa. According to access capital research (2010), in recent years, non-performing loans (a key measure of lending practices) have improved substantially and now average only about 5 percent of total loans. Bank loans are expected to be the main source of income and are expected to have a positive impact on bank profitability.

2.7.1.3 Management Quality

The performance of the other four CAMEL components will depend on the vision, capability, agility, professionalism, integrity, and competence of the Financial Institution's management. A sound management is crucial for the success of any institution; management quality is generally accorded greater weighting in the assessment of the overall CAMEL composite rating (brickwork rating 2008). The quality of the management will determine the success of a bank or financial institution. The performance of a bank is largely dependent on the vision, competence, and integrity and risk appetite of the management (Financial Management and Analysis of Projects 2006). The ratios of operating expenses to operating income and operating expenses to total assets are commonly used to measure Managerial efficiency of the banks. According to Indranarain (2009), Bourke (1989) and Molyneux and Thornton (1992), cited in Habtamu (2012) stated that Higher the efficiency level of a bank, higher its profits level. Hence a positive relationship is expected between efficiency and profitability of banks. The analysis of the quality of a management is based on the experience of the management and their track record in terms of their vision and competence in running the bank.

According to Tobias and Themba (2011), the analysis of the management also factors in their integrity and the overall corporate governance standards in the bank. The risk appetite in terms of the bank's exposure to various categories of asset, adoption of technology and responsiveness to competition and growth strategy impacts the bank's profitability thus is considered during the analysis of bank profitability (Brickwork ratings 2008). Although, the relationship between expenditure and profits appears straightforward implying that higher expenses mean lower profits and the opposite, this may not always be the case. The reason is that higher amounts of expenses may be associated with higher volume of banking activities and therefore higher revenues

2.7.1.4 Bank Size

Total assets of the bank measure bank size. In order to reduce the size effects, this study excludes Commercial Bank of Ethiopia. The size of the bank is included in this study, as an independent variable, which account for size related economies and diseconomies of scale. In most of the finance literature, the total assets of the banks are used as a proxy for bank size. However, since total assets deflated the dependent variable in the model (Return on Asset) it would be appropriate to take natural logarithm before including it in the model to be consistent with other ratios. Size is used to capture the fact that larger banks are better placed than smaller banks in harnessing economies of scale in transactions to the plain effect that they will tend to enjoy a higher level of profits. Consequently, a positive relationship is expected between size and profit (Indranarain 2009).

2.7.1.5 Earning Quality

The quality and trend of earnings of a bank depend largely on how well the management manages the assets and liabilities of the bank. A bank must earn reasonable profit to support asset growth, build up adequate reserves and enhance shareholders' value. Good earnings performance would inspire the confidence of depositors, investors, creditors, and the public at large (Financial Management and Analysis of Projects 2006). The quality of earnings of a bank determines the ability of the entity to meet debt obligations, the rate of growth of assets, reserves and ultimately the shareholders' value. The quality of earning coupled with the costs impacts the profitability. The quality of earning is also affected by the extent of asset liability mismatch and the resultant volatility in earnings due to changes in the interest rate (Brickwork ratings 2008). Generally a bank that depends more on leverage will experience more volatile earnings and this also affects the credit creation and liquidity function of the bank (Tobias and Themba 2011).

2.7.1.6 Liquidity

A bank or financial institution has to be liquid to meet payment obligations to depositors and creditors. This calls for a sound Asset Liability Management by the bank. Liquidity analysis considers the bank's ability to meet its obligations and is very critical for a bank to remain a going concern. The absence of liquidity can lead to failure of a bank. It also considers the proportion of liquid assets to total assets along with their deposit renewal rate (brickwork rating et. al, 2010). Abdus Samad *et al.* (2001) and Pak and Huh (1995) used loan to deposit ratio to

calculate the level of liquidity in their study. The liquidity condition of the commercial banks was also reliable in all cases, though some measures should be made by the individual banks respective to their matter as per (Habtamu 2004). A bank must always be liquid to meet depositors' and creditors' demand to maintain public confidence. There needs to be an effective asset and liability management system to minimize maturity mismatches between assets and liabilities and to optimize returns. As liquidity has inverse relationship with profitability, and banks must strike a balance between liquidity and profitability (Financial Management and Analysis of Projects 2006). According to Molyneux and Thornton (1992), and Guru *et al.* (1999), there is a negative and significant relationship between the level of liquidity and profitability. In contrast, Bourke (1989) reports an opposite result, while the effect of credit risk on profitability of banks appears clearly negative.

Current and quick ratios are inappropriate for measuring banks liquidity as per Brickwork rating (2008). A loan-to-deposit ratio is more relevant. However, a bank's liquidity and solvency are directly affected by portfolio quality. Consequently, financial analysts (investment officers) are carefully analyzing the bank's portfolio quality based on collectability and loan-loss provisioning. The trade-offs that generally exist between return and liquidity risk are demonstrated by observing that a shift from short term securities to long term securities or loans raises a bank's return but also increases its liquidity risks and the inverse is true. Thus management of liquidity level for the banks because it affect the bank's profitability (Tobias and Themba 2011). The new NBE directive were issued in 2012 related to the liquidity states that private commercial banks are obligated to allocate 27 percent of their gross loan disbursement to finance government bonds. Thus, this new directive will increase liquidity and loanable funds in the banking sector. As a result private banks could get temporary relief from the strain of illiquidity. They will also be able to disburse additional loans, since the additional liquid resources are beyond their operational needs (Addis fortune 15 January 2012).

2.7.1.7 Technology

European central bank (1999) stated that the information communication technology developments have had a strong influence on the structure and the activities of the banking sector. The elements that have changed are several, besides allowing transactions to be conducted more efficiently; technology allows banks to market their products more effectively.

The technology deployed in banks affects its operational efficiency and determines its competitive position in the market (Brickwork ratings 2008).

According to Thomas Ogoro *and others investigation* (2010), technological developments have removed repetitive, time consuming tasks, reduced human error and extended access to banking related facilities. Technology also provides customer information that it would be much more expensive to provide on a person-to-person basis. The dilemma still remains, however, as to how to maintain a satisfactory number of face-to-face interactions with the customers. Information technology developments affect banking in two main ways. First, it contribute to the reduction of the costs associated with the management of information (collection, storage, processing and transmission) by replacing paper-based and labor-intensive methods with automated processes. Second, it modifies the ways in which customers have accesses to banks" services and products, mainly through automated channels (remote banking). Whereas improvements in the area of information management have been taking place for a long time, remote banking is a more recent phenomenon with developments occurring more progressively, especially in retail banking (European Central Bank 1999).

2.7.1.8 Human Capital

The people in a bank are the most valuable resources and the major driving force for successes and failures. The quality of human resources employed by a bank greatly affects its profitability. The recruitment process and training standard of the financial institution, which reflects the quality of the people in the organization, their ability to guidance and support to operations staff, compensation package as per the industry norms and attrition rate in the financial institution, which reflect the satisfaction among the employees and staff towards their work and organization (Brickwork ratings 2008).

The human capital in organizations is valuable because of the capabilities that the people have. As part of the strategic role, Human Resource managers are often seen as responsible for expanding the capabilities of the human resources in an organization. Currently, considerable emphasis is being focused on the competencies that the employees in the organization have and will need the organization to grow in the future. Yet the mobility of human capital is less a threat to competitive advantage than it would first seem to be because once an organization integrates human capital with other complementary resources and uses this integration to create

organizational capabilities, losing one or a few individuals may not lead to a loss of competitive advantage (John I Njugun 2009, cited in Habtamu, 2012).

2.7.2. External Determinants of Bank Profitability

An external macroeconomic and industry-specific factor includes Effective tax rate, Real GDP growth, inflation, and regulation and Bank concentration and discussed as follows:

2.7.2.1 Gross Domestic Product (GDP)

Macroeconomic conditions affect banking profitability in a number of ways. Firstly, there will be a higher demand for bank credit in times of economic boom than in times of recession. Economic growth is measured by the real GDP sector profitability (for instance, Belayneh (2011), Andreas and Gabrielle (2009), and Athanasoglou *et al.* (2008). Accordingly, they expect a positive relationship between bank profitability and GDP development as the demand for lending is increasing (decreasing) in cyclical upswings (downswings).

According to Belayneh (2011) from microeconomic indicators, the only significant factor of bank profitability is real GDP growth. He stated that the current real 27 economic growth of the country makes commercial banks to be more profitable. A high aggregate growth rate may strengthen the debt servicing capacity of domestic borrowers, and therefore, contribute to less credit risk. Alternatively, adverse macroeconomic conditions hurt banks by increasing the amount of non-performing loans. Thus, it is expected that an improvement in economic growth enhance bank performance.

2.7.2.2 Bank Concentration

The bank concentration variable is defined as the ratio of the largest banks' assets to the total assets of the entire banking sector. Market structure in the banking industry measured by means of the bank concentration variable according to the structure conduct profitability of banks in highly concentrated markets earn monopoly rents, as they tend to collude (Gilbert 1984) cited in Habtamu (2012). As collusion may result in higher rates being charged on loans and lower interest rates being paid on deposits, a higher bank concentration have a positive impact on profitability. On the other hand, a higher bank concentration might be the result of a tougher competition in the banking industry, which would suggest a negative relationship between profitability and market concentration as stated in (Boone and Weigand 2000). As a result, the overall effect of market concentration on banking performance is again undetermined.

2.7.2.3 Inflation

High inflation is associated with higher costs as well as higher income. If a bank's income rises more rapidly than its costs, inflation is expected to exert a positive effect on profitability. Several economists have found that countries with high inflation rates have inefficiently small banking sectors and equity markets. This effect suggests that inflation reduces bank lending to the private sector, which is consistent with the view that a sufficiently high rate of inflation induces banks to ration credit as stated by John H. B and Bruce C. (2006). They also show the impact of inflation on asset returns and bank profitability, recall that the theory we have been discussing holds that inflation in sufficiently high doses kicks off a chain of events that ultimately leads to underdeveloped economic growth. The chain begins when high inflation lowers the real return on assets. They found that inflation is negatively associated with real money market rates, real Treasury bill rates, and real time-deposit rates; that is, as inflation increases, the real rate of return on these instruments falls. They found no significant statistical relationship between inflation and the real bank loan rate. However, inflation does appear to have a negative impact on bank profitability measures. According to access capital research (2010), private banks in Ethiopia are sometimes seen as generating “excessive” profits given the year-after-year returns of 25-30 percent that have been provided to shareholders for more than a decade now. However, seen from several perspectives, it is not at all apparent that banks’ profit levels should be seen as excessive. For example, real returns after accounting for the high inflation of the past five years are only in the range of 5-10 percent per annum, as annual inflation averaged 19 percent in the last five years (Habtamu, 2012).

2.7.2.4 Regulation

The banking industry is among one of the most heavily regulated industries in the world and Ethiopian banking industry also one the most heavily regulated industry. As quoted from Sudin Haron (1996), the main reason for regulation is to provide a sound, stable and healthy financial system, and Peltzman (1968) was among the first researchers to empirically test the effects of regulation on performance. Instead of profit, he used the bank's capital as a proxy for performance. Peltzman’s findings indicated that a prohibition on interstate branching and legal restrictions on new entry had a significant impact on the market value of a bank's capital. Fraser and Rose (1972) also studied whether the opening of new institutions had any significantly

adverse effect on the growth and profitability of competing institutions. They found that, despite some evidence of slowing in the growth rate of deposits, the profitability of existing institutions was not adversely affected by the opening of new branches by their competitors.

2.8. Interest Earned by Banks and Economic Growth

According to Haron & Ahmad (2002), cited in Aurangzeb (2012) investigates that The Effects Of Conventional Interest Rates And Rate Of Profit On Funds Deposited With Islamic Banking System In Malaysia by using 'Adaptive Expectation Model' to measure the effects of rate of profit declared by Islamic banks on the level of deposits placed by their customers. Data Variables are saving deposits, Interest-free, Rates of Profit, results shows that relationship between the amounts of deposits placed in the Islamic banking system in Malaysia and returns given to these deposits hence which are guided by the profit motive. It is recommended that these doctrines require that Muslims should not placed profit maximization as the sole factor in establishing relationship with Islamic banks.

According to Din and Khawaja (1995), cited in Aurangzeb (2012) investigated the determinants of interest spread of the banking industry in Pakistan. by using cross section data model, data variables Concentration, Inelasticity, Liquidity, Market Share, Equity, Non-performing Loans, Administrative cost, GDP growth, Inflation, Interest rate. Feasible Generalized Least Square (GLS) on pooled data technique has been used. Results shows that there is no evidence of interest spread which influence the performance factors of banking industry that also includes the other financial sectors example of which are DFI and investments funds that can serve as an alternate to banks for small savers, Bitzenis (2008) investigate and evaluate the banking reforms in Serbia by using survey data results. The study uses the approach of pre and post performance through many factors which are relevant to reformation of banking systems are reliability and management quality responsiveness in Serbia banking systems. Qualitative technique has been use for results however this article also concludes the different problems and challenges face by the current system and find out the result that is positive.

One of the major impediments affecting the performance and growth of many Ethiopian firms ,including those that are export-oriented, is the lack of short and medium-term finance at reasonable terms. A lending rate that has recently approached 10% in real terms (i.e. adjusted for

core inflation) is jeopardizing the private sector's international competitiveness and is not conducive to stimulating investment for increasing exports to other market.

This high interest rate level reflects the wide, increasing spreads between lending rates and deposit rates, which, in turn, are a symptom of structural weaknesses related to the financial difficulties of the most important lending institution, the Commercial Bank of Ethiopia (CBE), currently implementing a comprehensive restructuring plan. These problems are compounded by a lack of adequate competition among banks and the absence of a financial market.

2.9. The Banking Sectors in Transition Countries

Tuuli Koivu (2002), in his study presents an overview of banking sector development in transition countries. These banking systems typically evolved from the Soviet model, whereby a single bank was responsible for both monetary policy and commercial banking. In most central and eastern European countries (CEECs) and the Baltics, the monobank structure was abolished in the late 1980s. CIS countries introduced a more competitive system in the early 1990s. With the elimination of mono bank systems, most countries experienced a rapid expansion of the banking sector with the entry of a large number of new banks and corresponding declines in state ownership in the sector. Foreign banks entered the field in many CEECs and the Baltics in the second half of the 1990s. Rapid increases in stocks of non-performing loans led to banking crises in many transition countries during the 1990s. In fact, transition made banking sectors vulnerable in several respects. Many crises arose out of insolvencies in state-owned or formerly state owned banks caused by bad loans inherited from the Soviet era. Moreover, transition cut enterprise profitability in certain sectors, reduced the ability of companies to service their loans. Employees in the banking sector also lacked an understanding of profit-oriented approaches to business. The operating environment for banks deteriorated in conjunction with severe output contractions in the early part of transition. Finally, regulatory frameworks and supervisory structures for the banking system in most transition countries were inadequate (EBRD 1998, Tang et al. 2000). CEECs generally paid a higher price for their banking crises than the CIS countries, but they also ended up with sounder and more efficient banking systems. In CEECs, the average amount of credit allocated to the private sector has risen to about 25% of GDP in recent years. In CIS countries, the figure was only about 10% of GDP in 2000. The faster progress in the banking sectors in CEECs has led to a smaller amount of non-performing loans and the share of state

owned assets is currently lower in CEECs than in CIS countries. Although banking sectors are still underdeveloped in most transition economies, they are nevertheless the most important channel for domestic financing. Capital markets in these countries are small, volatile and illiquid. Indeed, the stock markets in some transition countries even face a danger of sliding into irrelevance as so many companies have been delisted in recent years. Thus, enterprises in transition countries have often financed capital investments out of their own cash flows or from lenders abroad. The level of domestic financing in many transition economies remains inadequate (Berglöf and Bolton 2002).

2.10. Developments in Financial Markets

Treasury bill market is the only regular market where securities are transacted on a weekly basis. There is no secondary market for the security. However, government bonds are occasionally issued to finance government expenditures and/or to absorb excess liquidity in the banking system. (NBE, 2013).

2.10.1. Bonds Market

In recent years, following the strong growth in economic activities and real income, there was strong demand for corporate bonds. As a result, corporate bond holdings of CBE increased to Birr 79.5 billion in 2012/13 from Birr 61.8 billion a year ago. The share of EEPCO from the outstanding corporate bond increased to 81.9 from 79.1 percent the previous year. While the holdings by Regional States and Saving Houses Development Enterprise accounted for 16.0 and 1.2 percent of the outstanding corporate bond, respectively. During the year, corporate bond issued by public institutions and regional governments reached Birr 21.9 billion, reflecting 6.1 percent reduction over last year. (Ibid).

2.10.2. Inter-Bank Money Market

The interbank money market was not active in Ethiopia due to the existence of excess reserves in the banking system. Accordingly, no inter-bank money market transaction was conducted after April 2008. Since the introduction of the interbank money market in September 1998, merely twenty three transactions worth of Birr 259.2 million were transacted with interest rates ranging between 7 to 11 percent per year. The maturity period of these loans widely spanned from overnight to 5 years. (Ibid).

CHAPTER THREE

RESEARCH METHODOLOGY

3.1. Research Design and Model

To find the long run relationship between the variables the researchers were used multiple regression analysis. The researchers were focused on secondary type of data. All secondary data were collected from the different official publications of respected banks, annual reports, and National bank of Ethiopia. In this study the researchers were designed to use six variables namely, gross domestic product, deposits, investments, advances, profitability and interest earned. And were try to cover the space modestly, and find out the relationship between factors which involve directly in the productivity and performance of banking sector and enhance the economic growth of the country.

After selection of the above variables the researchers described the economic growth function of the nation in the following way:

$$\text{GDP} = f(\text{DEP, INV, ADV, PRF, INE})$$

Where GDP is the gross domestic product, f represents the function of DEP, INV, ADV, PRF, INE represent respectively, deposits, investments, advances, profitability and interest earning. After specifying the trade balance function in linear form with an addition of error term, we can write in following way:

$$\text{GDP} = \alpha + \beta_1 \text{DEP} + \beta_2 \text{INV} + \beta_3 \text{ADV} + \beta_4 \text{PRF} + \beta_4 \text{INE} + e$$

Where α represents constant number, β (beta) represents responsiveness of independent variables with change in dependant variable and e is margin of error.

3.2. Sources and Methods of Data Collection

Secondary sources of data were used for the analysis. All secondary data were collected from the different official publications of respected banks, annual reports, National bank of Ethiopia and different publications related with banking sector development and economic growth.

3.3. Population, Sample and Sampling Procedures

Currently there were 19 private and public banks in Ethiopia, from this 3 banks are public and the rest 16 are private banks (see table 2.3.1). From the total population, 5 banks were purposely

selected (1 public and 4 private) by using the criteria; date of establishment (established before five years), size of bank (branch number, profit margin etc.) for this study.

The sampling technique chosen was purposive and the total numbers of observations were 25 taken from the selected banks (commercial bank of Ethiopia, Dashen bank, Awash International bank, Nib International bank, and Wegagen bank). In addition, banks financial statement and other reports of five years were used as secondary data.

3.4. Data Analysis

The collected data were analyzed with the use of the SPSS (statistical package for the social sciences) program 20v. The percentage, mean, standard deviation, coefficient of variation, correlation and multiple regressions was utilized. The reliability and internal consistency of the data were assessed using Cronbach's Alpha and the minimum acceptable level was above 80.

3.5. Limitations of the Study

In this study the researchers feared two main problems. The first one is related with the problem of representation to draw inference through all banks. This will be the gap for further study in a wide survey at the national level that can include all banks. The other pitfalls may be related with not using primary source of data for qualitative analysis of the nature and unavailability of full financial data of all banks.

CHAPTER FOUR

ANALYSIS AND DISCUSSION

4.1. Introduction

This chapter deals with the results of the study which include descriptive statistics of variables, correlation results for dependent and explanatory variables, diagnosis test for the regression models, and regression analysis for five GDP measures; deposit, Investment, profitability, Interest earned by banks, and loans or advances by banks and analysis of data gathered from NBE and discussion of results. Data analysis was done by using SPSS v.20 software. Mean, standard deviation, correlation, and ANNOVA test was adopted to discuss the relationship between dependent and independent variables and the impact of each independent variable on the GDP of the country.

4.2. Deposit Mobilization

The table 4.2.1 below shows that, the total deposit (saving, demand and time) mobilization of the banking sector has increased significantly from ETB 65.2 billion by the end of June 2009 to ETB 201.5 billion by the end of June 2013/14. The average annual growth rate in deposit was 26%. As can be observed from Table 4.1, Commercial bank of Ethiopia mobilized about 67% of total deposits mobilized by all commercial banks by the end of June 2009/10. This has shown only a small increase within the last 5 years and accounted for 77% in 2013/14. The total deposit mobilized by banks increased to 68% in 2013/14.

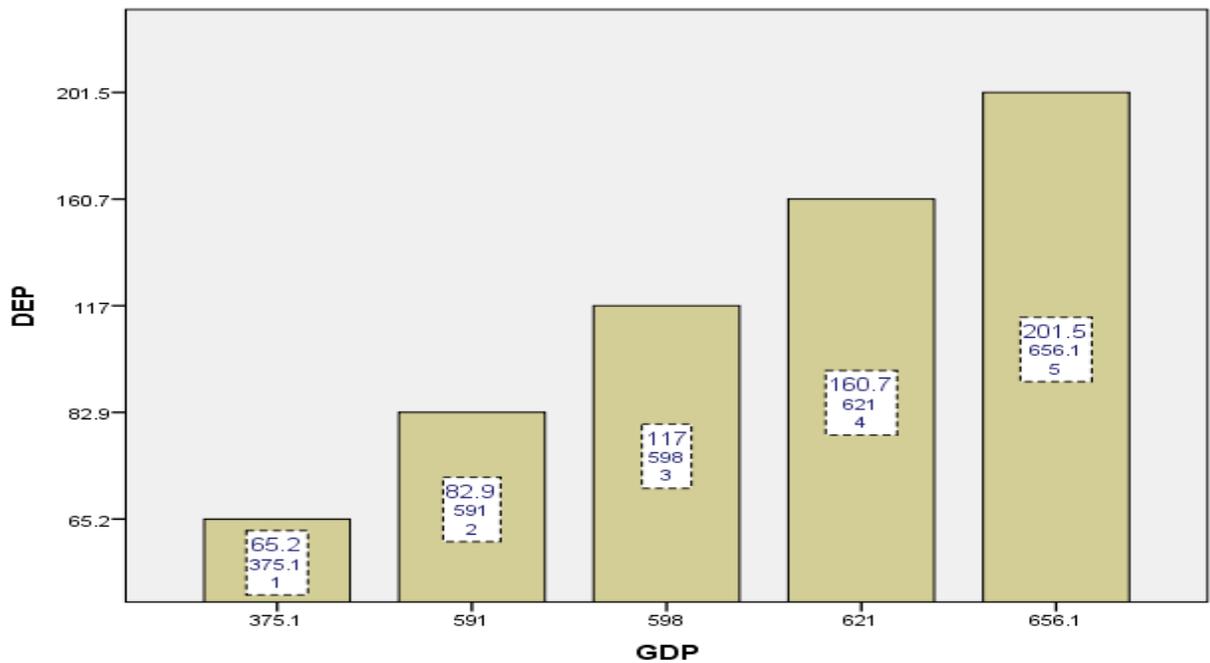
Table. 4.2. 1: Deposit Mobilizations of Selected Banks (in billion ETB)

N o	Name of the Bank	2009	2010	2011	2012	2013	% Change (2013/2009)
1	CBE	43.5	54.7	85.2	120.1	154.4	72
2	DB	7.9	10.1	11.8	14.1	15.9	50
3	NIB	3.3	4.1	4.7	5.8	6.7	51
4	WB	4.0	6.0	5.8	7.6	8.4	55
5	AIB	6.5	8.0	9.5	13.1	16.1	60
	Total	65.2	82.9	117	160.7	201.5	68

Source: NBE, Annual report of bank: own calculation

As shown in figure 4.2.1 deposit in 2009 was 65.2 billion ETB and in 2013 reached to 201.5 billion ETB, GDP was also 375.1 ETB in 2009 and reached to 656.1 billion ETB in 2013. It shows that both are shown significant increase at an average rate of 26% and 10% per annum for deposit and GDP respectively.

Figure 4.2.1 Growth of Deposit and GDP in billion of ETB (2009-2013 represented by case numbers 1-5)



Source: NBE and Commercial Banks annual reports: own calculation

4.3. Investment by Banks

The table 4.3.2 below shows that, the total investment by banks has increased significantly from ETB 25.9 billion by the end of June 2009 to ETB 104 billion by the end of June 2013/14. (75%) The average annual growth rate in investment by banks was 23%. As can be observed from Table 4.3.2, Commercial bank of Ethiopia mobilized about 96% of total investments mobilized by all commercial banks by the end of June 2009/10. This has shown only a small decrease within the last 5 years and accounted for 88% in 2013/14 due to an increase in the level of investment by other banks. The total investment mobilized by banks increased to 75% in 2013/14.

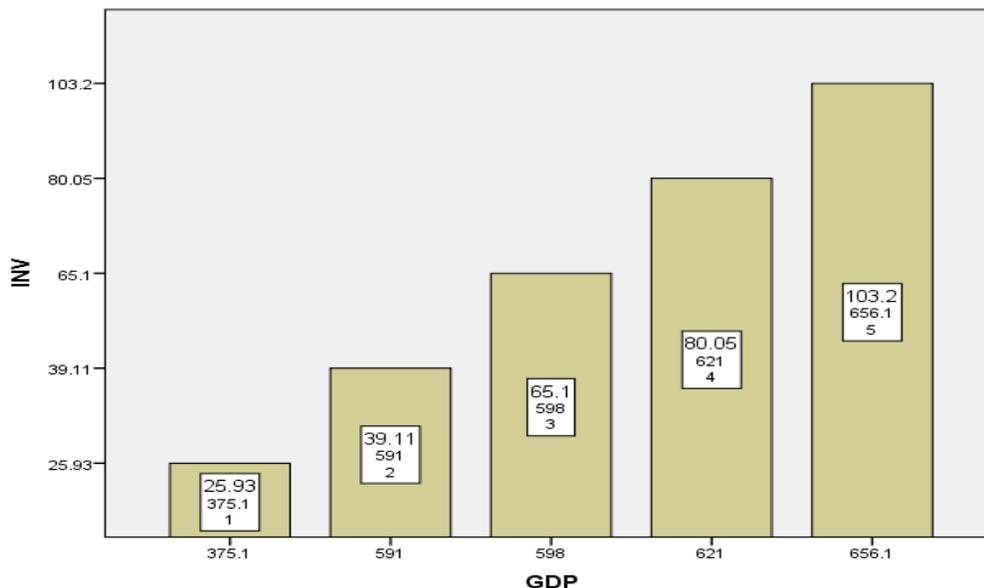
Table 4.3.2. Investment by Selected Banks (in Billions ETB)

No.	Name of the Bank	2009	2010	2011	2012	2013	% Change (2013/2009)
1	CBE	25	35.5	58.5	78	90	72
2	DB	0.03	1.4	1.7	2.85	3.75	99
3	NIB	0.004	0.51	1.1	1.5	2.15	99.8
4	WB	0.1	0.2	1.1	2.4	3.24	97
5	AIB	0.8	1.5	2.7	3.3	4.06	80
	Total	25.934	39.11	65.1	80.05	103.2	75

Source: NBE, Annual report of Banks: own calculation

The figure 4.3.2 shows that investment was increased from 25.93 billion ETB in 2009 to 103.2 billion ETB in 2013. GDP was also 375.1 ETB in 2009 and reached to 656.1 billion ETB in 2013. It shows that both are shown significant increase at an average rate of 23% and 10% per annum for investment and GDP respectively.

Figure 4.3.2 Growth of Investment and GDP in billion of ETB (2009-2013 represented by case numbers 1-5)



Source: NBE and Commercial Banks annual reports: own calculation

4.4. Loan or Advances

The banking sector is one of the major sources in financing the economy by providing loan to individuals, firms and the Government. Total loans disbursed by the banking sector reached 176 billion in 2012/13 and indicating nearly fivefold increase to the level of loan disbursement in 2009/10 (Table 4.4.3). The average annual rate of growth of loan disbursement by the banking sector over 2009 – 2013 period was 26%.

According to NBE (2013), Lending is one of the most important activities of the banking system in any economy. In this regard, Commercial Banks and DBE disbursed Birr 54.3 billion to various economic sectors. The fiscal year witnessed a 3.3 percent decrease in fresh loan disbursements by banks despite the surge in deposit mobilization capabilities of banks and loan collection that can be re-lent again without affecting the outstanding limits. Of the total new loans disbursed by the banking system, 38.7 percent was provided by private banks, while the public bank took the remaining balance. The ratio of new loan disbursement by the private banks to their total deposit at the end of the fiscal year stood at 27.4 percent while that of public bank was 20.7 percent. Regarding loan allocation by sector, 35.6 percent went to Industry followed by Agriculture (17.9 percent) and domestic trade (15.3 percent), while other sectors consumed the remaining balance. The share of the new loan disbursement to the production sector (agriculture, industry and housing & construction) rose from 63.8 percent last year to 65.1 reflecting the shift in loan from trade and other short term loans towards the production sector. Total Outstanding credit of the banking system including the central government increased by 30.1 percent and reached Birr 151.3 billion at the end of June 2013. Gross outstanding claims on the central government and public enterprises increased by 152.4 and 47.6 percent, respectively while claim on the private sector also surged by 20.6 percent. The sectorial distribution of outstanding loans indicated that credit to Industry accounted 32.2 percent followed by International trade (18.2 percent) and agriculture (11.0 percent). Outstanding claims on the private sector including cooperatives stood at Birr 94.8 billion or 62.7 percent of the total outstanding claim reflecting a 15.3 percent growth in 2012.

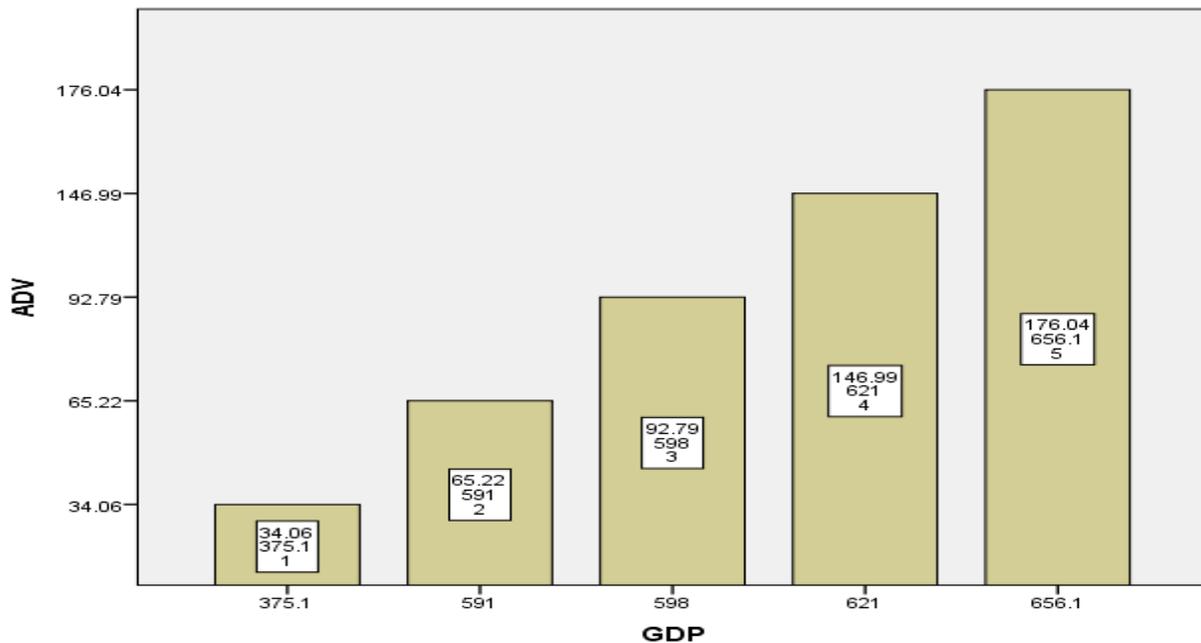
Table 4.4.3. Loans or Advances by Selected banks (in Billions ETB)

No.	Name of the Bank	2009	2010	2011	2012	2013	% Change (2013/2009)
1	CBE	22.86	50.85	74.62	123.00	149.00	85
2	DB	4.35	4.94	6.10	7.90	8.70	50
3	NIB	2.20	2.54	3.00	3.71	4.54	51
4	WB	1.50	2.91	3.57	4.69	4.60	67
5	AIB	3.15	3.98	5.50	7.70	9.20	66
	Total	34.06	65.22	92.79	146.99	176.04	81

Source: NBE, Annual report of banks: own calculation

As shown in figure 4.4.3 advances or loans in 2009 was 34.06 billion ETB and in 2013 reached to 176.04 billion ETB, GDP was also 375.1 ETB in 2009 and reached to 656.1 billion ETB in 2013. It shows that both are shown significant increase at an average rate of 26% and 10% per annum for advance or loans and GDP respectively.

Figure 4.4.3 Growth of Advance or Loans and GDP in billion of ETB (2009-2013 represented by case numbers 1-5)



Source: NBE and Commercial Banks annual reports: own calculation

4.5. Profitability of Banks

The data presented in the table 4.5.4. showed that the total profit earned by banks were recorded a significant increase from ETB 2.6 billion by the end of June 2009 to ETB 7.4 billion by the end of June 2013/14 (which was about 67 %). The average annual growth rate in profitability by banks was 18%. As can be observed from Table 4.5.4, Commercial bank of Ethiopia earned about 73% of total profit earned by commercial banks by the end of June 2009/10. This has shown only a small increase within the last 5 years and accounted for 80% in 2013/14 over the total profit earned by banks.

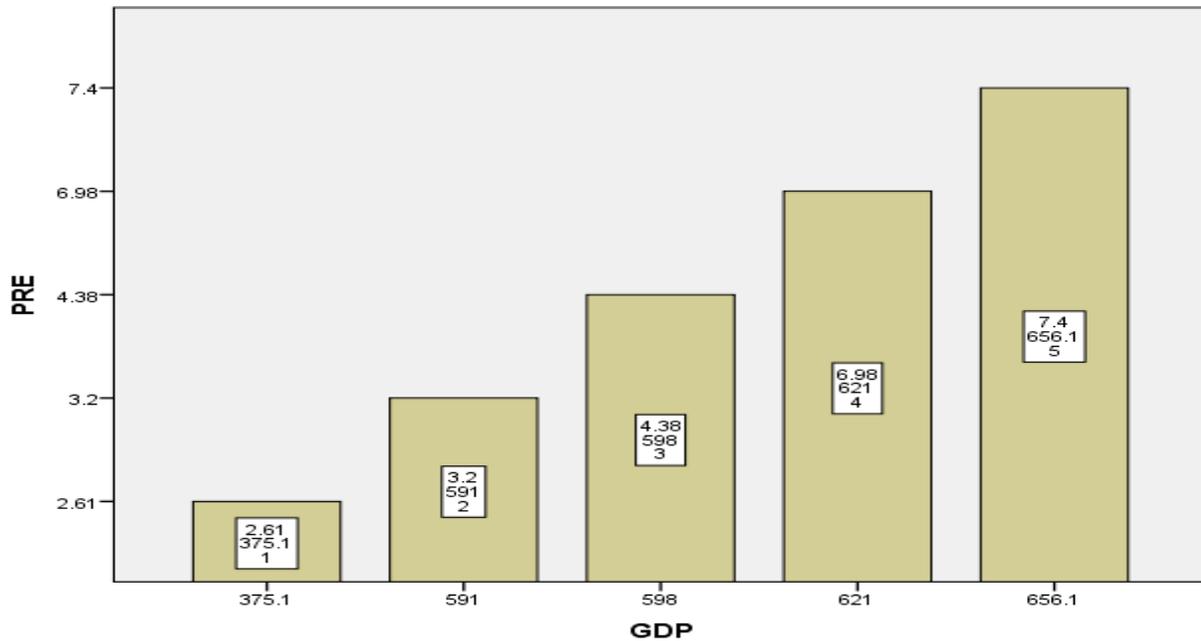
Table 4.5.4. Profitability of Selected Banks (in Billions ETB)

No	Name of the Bank	2009	2010	2011	2012	2013	% Change (2013/2009)
1	CBE	1.92	1.97	2.9	5.4	5.9	67
2	DB	0.25	0.32	0.45	0.65	0.51	50
3	NIB	0.15	0.20	0.21	0.29	0.29	48
4	WB	0.18	0.46	0.46	0.25	0.26	31
5	AIB	0,11	0.25	0.36	0.39	0.44	75
	Total	2.61	3.2	4.38	6.98	7.4	65

Source: NBE, Annual report of banks: own calculation

The figure 4.5.4 shows that profit was increased from 2.61 billion ETB in 2009 to 7.4 billion ETB in 2013. GDP was also 375.1 ETB in 2009 and reached to 656.1 billion ETB in 2013. It shows that both are shown significant increase at an average rate of 18% and 10% per annum for profit and GDP respectively.

Figure 4.5.4 Growth of Profit and GDP in billion of ETB (2009-2013 represented by case numbers 1-5)



Source: NBE and Commercial Banks annual reports: own calculation

4.6. Interest Earned by Banks

The table 4.6.5 below shows that, the total interest income by banks has increased significantly from ETB 3.57 billion by the end of June 2009 to ETB 12.76 billion by the end of June 2013/14. (72%). The average annual growth rate in interest income by banks was 21%. As it can be seen from Table 4.6.5, the share of interest income by Commercial bank of Ethiopia was about 66% of total interest income by all commercial banks by the end of June 2009/10. This has shown an increase within the last 5 years and accounted for 75% in 2013/14.

Different empirical studies investigated that, Narrow and declining interest rate spread over time would imply the prevalence of competition. In Ethiopian banking industry, the interest rate structure, and hence the spread, remains more or less constant over time with few exceptions. Since 2002, the saving rate (the major component of total deposit in magnitude) was declined by half and remains intact till 2007. However, the average rate of time deposit has been steadily rising since 2002. Interest rate on demand deposit (by few banks) was commenced in 2002 which

had been non existence before. Due to marginal changes in time and demand deposits since 2002, the spread has displayed a slightly declining trend in Ethiopian Banking system.

The spread between the nominal lending and deposit rates in the industry is low, while real lending and deposit rates are currently negative. However, the commencement of interest rate on demand deposits, the differentiated interest rates on saving and time deposits, the increasing trend in interest rate of average time deposits since 2002, and the concomitant marginal decline in the interest rate spread somewhat indicate improvements in competition, though not intense, among commercial banks, especially in mobilizing deposits to avail adequate funds for the growing demand for loans. It may seem a truism to deduce that there is no vigorous price competition in the Ethiopian banking industry. Price is not yet set based on demand and supply forces over the review period.(Zerayehu Sime, Kagnaw Welde and Teshome Ketema, 2013). Currently, the banking sector has showed a significant increase in interest income earned by banks within narrow rate of interest.

According to NBE (2013), in 2012/13 fiscal year, both minimum and maximum deposit interest rate did not show any change to the rates of the past two years and continued to register rates of 5.0 and 5.75 percent respectively. Consequently, average interest rate on savings deposit remained intact at its preceding year balance of 5.38 percent. On the other hand, the weighted annual average interest rate on time deposit increased to 5.66 percent from 5.55 percent in last year. The average demand deposit rate banks pay increased by one basis point from last year rate. Average lending rate, however, witnessed no change from last year balance of 11.88 percent. Despite the negligible change in nominal interest rates the real rate of interest showed a significant improvement from the past year as a result of the drop in the year-on-year headline inflation from 20.9 to 7.4 percent. Consequently, the real rate of lending rate recorded a positive value of 4.8 percent for the first time since 2009/10. However, the other real interest rates including yield on T-Bills remained negative during the review fiscal year.

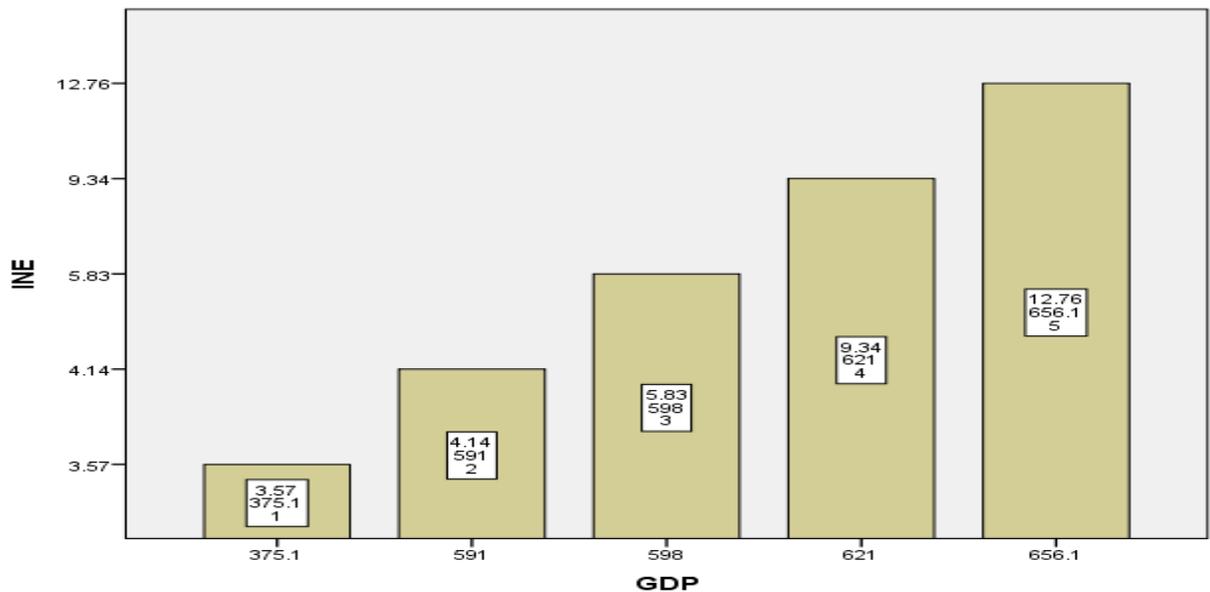
Table 4.6. 5. Interest Earned by Selected Banks (in Billions ETB)

No.	Name of the Bank	2009	2010	2011	2012	2013	% Change (2013/2009)
1	CBE	2.36	2.74	4.08	6.70	9.54	75
2	DB	0.43	0.48	0.60	0.90	1.02	58
3	NIB	0.25	0.27	0.23	0.43	0.57	56
4	WB	0.23	0.25	0.25	0.41	0.43	47
5	AIB	0.30	0.40	0.67	0.90	1.2	75
	Total	3.57	4.14	5.83	9.34	12.76	72

Source: NBE, Annual report of banks: own calculation

As shown in figure 4.6.5 interest income was increased from 3.57 billion ETB in 2009 to 12.76 billion ETB in 2013. GDP was also 375.1 billion ETB in 2009 and reached to 656.1 billion ETB in 2013. It shows that both are shown significant increase at an average rate of 21% and 10% per annum for interest income and GDP respectively.

Figure 4.6.5 Growth of Interest Income and GDP in billion of ETB (2009-2013 represented by case numbers 1-5)



Source: NBE and Commercial Banks annual reports: own calculation

Table 4.7.6. Percentage change in GDP and the Variables (in Billion ETB)

Year	GDP	DEP	INV	ADV	PRF	INE
2009	375.1	65.2	25.93	34.06	2.61	3.57
2010	591.0	82.9	39.11	65.22	3.2	4.14
2011	598.0	117	65.1	92.79	4.38	5.83
2012	621.0	160.7	80.05	146.99	6.98	9.34
2013	656.1	201.5	103.2	176.04	7.4	12.76
% Change2013/2009	42.8	68	75	81	65	72
% share to GDP		22	11	18	0.86	1.2

Source: NBE, Annual report of banks: own calculation

Table 4.7.8. Descriptive Statistics

	GDP	DEP	INV	ADV	PRF	INE
Mean	568.11	125.5	62.68	103.02	4.91	7.13
Maximum	656.10	201.5	103.2	176.04	7.4	12.76
Minimum	375.10	65.2	25.93	34.06	2.61	3.57
Std. Dev.	110.916	55.986	31.046	58.211	2.178	3.869
Observations	25	25	25	25	25	25

Source: NBE, Annual report of banks: own calculation.

The table 4.7.8 represents the descriptive statistics of the model. In the above table GDP is a dependent variable and DEP, INV, ADV, PRF and INE are independent variables. The sample size comprises of 25 observations from the period of 2009 to 2013 of five banks. The minimum and maximum value of GDP (375.10) and (656.10) respectively, whereas the mean value is (568.11) and standard deviation is (110.916). The minimum and maximum value of DEP (65.20) & (201.5) respectively, whereas the mean value is (125.5) and standard deviation is (55.986). INV having minimum value (25.93), maximum value (103.2), mean value (62.68) and standard deviation (31.046). ADV having minimum value

(34.06), maximum value (176.04), mean value (103.02) and standard deviation (58.211). PRE having minimum value (2.61), maximum value (7.4), mean value (4.91) and standard deviation (2.178). INE having minimum value (3.57), maximum value (12.76), mean value (7.13) and standard deviation (3.869).

Table 4.7.9 Results of OLS

Variables	Coefficient	t-Statistic	Probability	VIF
C	0.813	11.456	0.000	
DEP	0.763	5.011	0.067	2.39
INV	0.807	4.514	0.050	2.87
ADV	0.809	3.957	0.049	2.89
PRE	0.742	5.044	0.075	2.22
INE	0.694	4.119	0.095	1.92
R-squared	1.000			
Durbin Watson	1.9878			
F Statistics (Probability)	118.496 (0.000)			

Source : Statistical results

In the above table GDP is a dependent variable and DEP, INV, ADV, PRF and INE are independent variables. Table 4.7.9 gives us the value of R square, which represents the correlation between the observed values and predicted values of the dependent variable. R-Square is called the coefficient of determination and it gives the adequacy of the model. Here the value of R-Square is 1.000 that means the independent variable in the model can predict 100% of the variance in dependent variable. The p-value is given by 0.000 which is less than 0.05, which shows the significance of the model. The values of Durbin-Watson statistics for dependent variables in our case is very near to 2.00 (1.9878), this indicates that there is no autocorrelation exists in our study and the regression models assume that the error deviations are uncorrelated.

The Beta value shows the relationship between the variables in the model, if the value of coefficient is positive it means that independent variables have positive relation with

dependent variable i.e. increase in dependent variable is caused by increase in independent variable and if the value of coefficient is negative than independent variables are having negative relation with the dependent variable i.e. decrease in dependent variable is caused by increase in dependent variable. The values of coefficients beta and constant are used to construct the regression model, the model is shown below:

$$\text{GDP} = 0.813 + 0.763 (\text{DEP}) + 0.807 (\text{INV}) + 0.809 (\text{ADV}) + 0.742 (\text{PRF}) + 0.694 (\text{INE})$$

Beta coefficient shows the tendency of an independent variable to respond against dependent Variables. Therefore greater value of beta indicates the larger impact on dependent variable and vice versa. Deposits (0.763), Investments (0.807), advances (0.809), profitability (0.742) and interest earnings (0.694) all are having positive and significant impact on the economic growth because the p-value is less than 0.05, that's mean if DEP, INV, ADV, PRF and INE are increase then the GDP will also increase.

In table 4.7.9 column label P-value shows that advances and investment have unique significant contribution but deposit, profit and interest has no unique significant contribution because their p-values are greater than 0.05, i.e., deposits (DEP) has (0.067), investments (INV) has (0.050), advances (ADV) has (0.049), profitability (PRF) has (0.075) and interest earnings (INE) has (0.095) therefore all variables are significant. VIF is the test of multi co linearity among the variables (Excessively high correlation among the independent variables). The rule of thumb describe that $VIF > 10.0$ indicates multi co-linearity problem among the variables, since the table 4.7.9 shows that no variable have VIF value > 10.0 , so therefore multi co-linearity does not exist in this model. Durbin-Watson test was used to test autocorrelation among the data (error term). In Durbin-Watson test, indicates that autocorrelation does not exist in error term. Since regression model has assumption of uncorrelated error term therefore it must be fulfilled to run regression analysis. In Table 4.7.9 indicated value of Durbin Watson as 1.9878 which shows that autocorrelation does not exist in error term. Regression model Overall significance has identified by F-value. It is actually the explained variance divided by unexplained variance (mean error). In table 4.7.9 F-statistics shows the value (118.459) and it's Probability (0.000).

CHAPTER FIVE

CONCLUSIONS AND RECOMMENDATIONS

5.1 Conclusions

This study was investigated the contributions of banking sector in economic growth of Ethiopia. The data used in this study were collected from the period of 2008/9-2012/13 of five banks. The researchers used a GDP Growth model and data from five commercial banks in Ethiopia for the period 2008/9-2012/13. The researchers used five variables to measure the level of economic growth. Regression results indicate that deposits, investments, advances, profitability and interest earnings have significant positive impact on economic growth of Ethiopia. The value of R-Square is 1.000 that means the independent variable in the model can predict 100% of the variance in dependent variable. The p-value is given by 0.000 which is less than 0.05, which shows the significance of the model. The values of Durbin-Watson statistics for dependent variables in our case is very near to 2.00 (1.9878), this indicates that there is no autocorrelation exists in our study and the regression models assume that the error deviations are uncorrelated. The Beta value shows the relationship between the variables in the model, if the value of coefficient is positive it means that independent variables have positive relation with dependent variable i.e. increase in dependent variable is caused by increase in independent variable and if the value of coefficient is negative than independent variables are having negative relation with the dependent variable i.e. decrease in dependent variable is caused by increase in dependent variable. The values of coefficients beta and constant are used to construct the regression model. Beta coefficient shows the tendency of an independent variable to respond against dependent Variables. Therefore greater value of beta indicates the larger impact on dependent variable and vice versa. Deposits (0.763), Investments (0.807), advances (0.809), profitability (0.742) and interest earnings (0.694) all are having positive and significant impact on the economic growth (unique contribution, ADV and INV) have the p-value less than 0.05 , that's mean if DEP, INV, ADV, PRF and INE are increase then the GDP will also increase. In our study the percentage share of DEP, INV, ADV, PRF, and INE to GDP between 2009 and 2013 shows an average of 22, 11, 18, 0.86 and 1.2 percent respectively.

It leads to recommend that the policy makers should make policies to enhance the banking sector in Ethiopia because banking sector is significantly contributing in the economic growth of Ethiopia. This paper examined the link between the banking sector and real GDP growth in the country.

5.2 Recommendations

According to different empirical studies, when the financial sector or the business environment is not ready for growth in the amount of finance, growth in the amount of finance may be unsustainable and do nothing to accelerate economic growth. In the worst case, such growth in the amount of available finance may precipitate financial crises and harm economic development.

The results may be in line with the theoretical and empirical models that indicate quantitative financial sector development that accelerates economic growth.

Different empirical studies show that banks play key role in an economy in terms of enhancing both allocation and productive efficiency. An efficient banking industry will make the largest contribution to economic growth (GDP). Conversely, when a banking system does not work well or when there is instability, inefficiency, and non-competitiveness, there will be substantial economic costs. Thus, like in other industries, banks are significant to enhance social welfare, optimizing efficiency and stability, and contributing for GDP growth. However, there is no consensus in literature as to which competitive structure optimizes both efficiency and stability and the contributions of the sector for economic growth with relevant economic model considering the factors affecting the banking sector development. It could be possible for banking efficiency to be benefited from competition, stability, growth, and size, enhancing the level of deposit, investment, advances, profitability, and interest earned by banks.

In Ethiopian context, the financial system is dominated by banking industry, and yet, it is amongst the major under banked economy in the world. There are merely 19 commercial banks (of which 2 are public) and one government owned development bank.

Few of the researchers (Habtamu, 2012, Zerayehu Sime, Kagnaw Wolde, and Teshome Ketama, 2013) investigated that Bank service charges are more or less homogeneous in the industry, whereas interest rates on time and saving deposits are partially controlled by monetary authorities, rather than demand and supply forces. However, after satisfying the minimum

statutory levels, banks have been engaging in price competition, as can be explained by differentiated rates on deposits, especially on time deposit, the commencement of interest payment on demand deposit, as well as differentiated interest rates on loans. The econometric study also confirms that the performances are governed largely by macroeconomic performances than competitive parameters as high (low) performances coincided with good (bad) macroeconomic conditions. The Ethiopian banking industry can be characterized as highly profitable, concentrated and moderately competitive. In terms of contestability, the Ethiopian banking industry can be characterized as incontestable as entry in the industry is difficult, due to legal, technological and economic factors. However, there are some potential that may improve contestability, such as the possibility of monopolistic competition among banks in terms of prices. In a nut shell, banks in the Ethiopian case are competing in terms of service quality and efficiency (including use of technological advances), branch network expansions, advertising and prices, put in the order of their significance.

Based on the findings of the study (banks have significant contribution on the growth of GDP) ,some recommendations are given below to enhance the contribution of the banking industry for the economic growth.

- Increasing competition between banks through promotion and advertising. Interest earnings without competition, banks are prone to inefficiency or they are able to earn excess returns through charging a wide margin between deposit and lending rates. Besides, some viable projects may remain unfinanced or financed only at excessive costs. If banks are strengthened by the gymnastics of competition, the banking system would be stronger and more resilient to shocks. Therefore, it is apparent to give due regard to interest rate margins, which are mainly related to promoting competition and increasing savings, and at the same time rectifying information asymmetry related problems.
- For enhancing deposit mobilization by banks, relaxing entry requirements for banks and creating legal framework for the establishment of additional branches (niche banks) is important to enhance competition and avoid dominance by banks to provide more choices to customers and thereby enhancing societal welfare. The successful introduction of niche banks should coincide with the introduction of a comprehensive deposit-guarantee scheme which may assist in preventing niche bank failures leading to contagion.

- There should be an increase adoption of e-money and mobile banking to enhance transactions among customers and establishment of directives enabling electronic transmission facilities by suitably regulated institutions since such implementation may lessen the dependency on cash for lower income earners and create healthy competition and velocity of money.
- To achieve the required competition it is important to design and implement competition policy in the banking industry. Competition policy that can be seen as a forum of regulation intended to bring about the best of laissez faire. Effective competition policy is, in economic terms, the consumers' best friend. The newly designed competition policy should consider the prevailing economic environment and all the pros and cons to arrive at optimal competition policy. The effort in this regard should not focus on avoiding concentration, as concentration may not negatively correlate with competitiveness, but rather on improving contestability to bring about effective competition.
- Avoiding asymmetry information among banks and customers, investors, and others. There is also a need for strengthening the supervisory authority (NBE) and improving the quality of information. It is likely advisable to allow foreign participation in the banking industry to some degree and increase foreign capital and FOREX inflow. NBE should be understandably cautious in opening up to foreign banks with unfamiliar procedures and potentially doubtful reputations. NBE is expected to grade the quality of foreign banks. However, NBE's supervisory capacity is not developed and it may be difficult to regulate these technologically advanced foreign banks. Therefore, it is indispensable for the NBE to prepare itself to monitor and supervise foreign banks proficiently in order to minimize adverse effects in an environment hither to unfamiliar to it.
- The adoption of latest and important information and technology used for the banking industry. The Credit Information Center (CIC) in the NBE should be strengthened with appropriate manpower and information technology facilities to rectify the problems associated with information asymmetries and to provide timely and reliable information exchange among banks about borrowers.
- There is a need to structurally strengthen the NBE by establishing or assigning an organ that regularly follows up competitive conditions over time, and be aware of the extent of

the prevailing competition aiming at maintaining stability and efficiency. This organ is assumed to regularly evaluate the pros and cons of competition and suggest how optimal competitive environment will be achieved. Development of competitive information system will be also a function of this organ. It also suggests as to how to relax regulation and update competition policy to make competition effective without compromising the stability objective.

- There is a need to prepare fertile grounds to opening up a capital market. Opening up a capital market may bring about additional options of investment for savers, which may strengthen competition.

Finally, all the concerned bodies including National bank of Ethiopia need to understand the competition level of banking industry, stability of the sector, and the contribution level of the sector in Ethiopia in order to scale up and strengthen financial sector development. It is also important to take a lesson from other developing and developed countries and adapts important practices of financial sector into Ethiopian economy.

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