

MERITS AND DEMERITS OF ALLOWING ENTRY OF FOREIGN BANKS INTO THE ETHIOPIAN BANKING SECTOR: LESSONS FROM SELECTED COUNTRIES

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Abstract

The main objective of this study is to analyse the benefits and costs of participation of foreign banks in the Ethiopian banking sector by providing empirical evidences from selected countries, and then from their experiences to draw certain policy implications that are relevant to particular situations of the country. The study will use simple descriptive statistics to examine costs and benefits of foreign banks' entry into the Ethiopian banking sector.

As in the case of other developing countries although participation of foreign banks in the Ethiopian banking sector has some potential risks such as foreign banks' dominance in the financial sector, exposure of the host country's economy to economic shocks and fluctuations in home countries, less credit to small and medium-sized enterprises (SMEs) and profit remittances and capital flight especially during economic crisis, which lead to shortage of foreign exchange, the key conclusion of this study indicates that it has significant benefits to the growth of real sectors in general and financial sectors in particular in the country. The benefits include improving efficiency in the banking system through competitive pressures on local banks, higher economic and income growth, increasing know-how in the banking services, ensuring overall economic and financial stabilities and enhancing technological progress and innovations in the banking sector. Thus, foreign banks' participation in the Ethiopian banking sector is very crucial in enhancing overall development in general and financial sector development in particular.

1. INTRODUCTION

1.1. A Brief History of Foreign Banking in Ethiopia

In Ethiopia, modern banking services started in 1905 with the entry of the foreign-

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owned "Bank of Abyssinia", which was based on 50 years franchise agreement with the Anglo-Egyptian National Bank. The agreement was immediately signed between Menelik II and Mr. D. Mac Gilliuray, the representative of the National Bank of Egypt, and the bank started its operation on Feb. 16, 1905. The major terms of the agreement included the fixed capital of the bank which was half a million pounds sterling of which 20 per cent was subscribed and the balance was collected by selling shares in large cities like London, Paris and New York; the sole right of issuing bank notes and minting coins was given to the newly established bank; and all government and public funds were to be deposited with the bank, and all payments were made by checks. It opened branch offices in some parts of the country like Dire Dawa, Gore and Dessie, and was involved in limited activities such as keeping government accounts and export financing. Moreover, two other foreign banks (named Banque de l'Indochine and the Compagnie de l'Afrique Orientale) and a new development bank (société nationale d'Ethiopie Pour le Developpement de l'Agriculture et du Commerce) were established in 1915 and 1908, respectively. Since all of these banks were wholly foreign owned, they were criticized, and as a result the Bank of Abyssinia was purchased by the Ethiopian government in 1931, which was re-named as the State Bank of Ethiopia—the first nationally owned bank on the African continent (NBE 1999 and Alemayehu 1999).

Foreign banking activities particularly those of Italian banks were expanded during the five years of the Italian occupation. Year of establishment (European year), name of bank and number of their branches are given in Table 1.1 below.

After the Italian occupation of 1933-1941, British banks became active participants in the Ethiopian banking sector due to political reasons and hence Barclay's bank had been established and was in operation in the country from 1941-43 (Alemayehu 1999).

Table 1.1: Foreign Banks Operating in Ethiopia During the Italian Occupation

Year of Establishment (European Year)	Name of Bank	Number of Branches
1914	Banco di Italia	9
1914	Banco di Roma	18
1939	Banco di Napoli	4
1939	Banco Nazionale (De's voro)	4
1939	Casa de Creito...	1
1939	Societe Nazionale di Ethiopia	4
Total		37

Source: Alemayehu 1999.

In 1963, Monetary and Banking Proclamation No. 206 was introduced in the financial sector of the country. The basic idea of this proclamation was that a license to carry on banking business in Ethiopia was granted only to those with partnerships with

Ethiopian nationals; the Ethiopian nationals owning at least 51% of the capital. Accordingly, foreign banks, which had already started their operations in the country re-applied for license (NBE 1999).

Following the emergence of the military government in 1974, however, all foreign banks operating in the country in the form of partnership were nationalized and re-organized, and thereby the following financial institutions were created: one national bank (re-institutionalized in 1976), a commercial bank (the Commercial Bank of Ethiopia), two specialized banks (the Agricultural and Industrial Bank and Housing and Saving Bank), which currently are re-named as the Development Bank of Ethiopia (DBE) and the Construction and Business Bank (CBB), respectively, Ethiopian Insurance Corporation and the Pension and Social security Authority (Berhanu and Befakadu (2000).

Since the economic reform of 1992 under the new government, these financial institutions have been re-organized so that they may operate on the basis of market-oriented economic policy framework. During the period 2001, for instance, there were three state-owned commercial banks (including Development Bank of Ethiopia) with a total number of 223 branches (or 71% of the total banking sector) providing modern banking services in the country. Moreover, new Ethiopian privately-owned financial institutions have been allowed to participate in the country's financial sector. Accordingly, as of June 30, 2001, for instance, six Ethiopian privately-owned commercial banks with a total number of 92 branches (or about 29% of the total banking sector) were engaged in the banking business in Ethiopia.

However, from the time of nationalization onwards (or since 1974), no foreign bank has been allowed to operate in Ethiopia.

1.2. Structure and Performance of the Banking Sector in the Post-Reform Ethiopia: A Brief Review

The 1992 economic reform in Ethiopia was a benchmark in the Ethiopian economy in general and the financial sector in particular where a number of policy changes have been introduced gradually in the financial sector of the country. These policy changes include interest rate deregulation, exchange rate liberalization, left credit ceiling, avoid credit discriminations and allowing entry of Ethiopian privately-owned financial institutions. Hence, currently, nine commercial banks (including the Development Bank of Ethiopia) of which six Ethiopian privately-owned commercial banks are actively operating in the banking system of the country.

Since the economic reform, the Ethiopian banking sector has witnessed an encouraging performance in terms of deposit mobilization, credit disbursement, branch expansion and loan collection. In particular, deposits mobilized and credits

disbursed of the banking sector swung up from about 10.1 and 3.3 billion Birr in 1995 to 23.2 and 4.1 billion Birr in 2001, respectively. Branch expansion and loan collection also increased over the same period (see Table 1.2).

The close analysis of the performance of the private banks revealed that the banking system in the country has been promising. That is, the relative share of the private banks in deposits mobilization and credits disbursement raised from 4.2 and 6.6 per cent in 1997 to 13.7 and 36.6 per cent in 2001, respectively, with increasing trends implying the importance of private banks in the banking system of the country. The relative share of branch expansion in the total banking sector was moved up from 12.4% to more than 29% over the respective period (see Table 1.2). Despite its encouraging performance in all aspects (i.e., deposits mobilization, credits disbursement and branch expansion), the banking sector is still dominated by the state-owned banks particularly the Commercial Bank of Ethiopia (CBE). However, this dominant position of the CBE has been declining over time leaving its market shares to the newly emerging private banks.

In general, the market shares of private banks in terms of deposits mobilization, credits disbursement and branch expansion have been increasing while that of public banks declining over time implying that private sectors and their importance have been increasing in the banking sector.

Given this historical background and the brief review of the structure and performance of the banking sector in the country, the main objective of this study is to examine costs and benefits of allowing participation of foreign banks in the Ethiopia banking sector by providing experiences of selected countries. Then, the study provides concluding remarks and policy implications relevant to the specific situation of the country.

The rest of the study will be organized as follows. The second section summarizes existing literatures on benefits and costs of allowing foreign bank entry in the selected countries from Africa, Asia and Latin America, to draw lessons for Ethiopia. The third section will discuss potential pros and cons of allowing entry of foreign banks in the Ethiopian banking industry. Finally, certain concluding remarks and policy implications relevant to the country will be drawn.

Table 1.2: Basic Indicators of the Performance of Banking Sector (1995-2001)

	1995	1996	1997	1998	1999	2000	2001
Total Deposits (in mil. Birr)							
Public	10075.5	11640.9	13299.2	16718.2	16350.6	18149.7	20070.7
Private	33.6	363.2	582.4	987.0	1525.7	2234.4	3077.3
Total	10109.1	12004.0	13881.6	17705.2	17876.3	20384.2	23148.0
Share of Private	0.3	3.0	4.2	5.8	8.9	11.4	13.7
Total Loans (Outstanding) (in mil. Birr)							
Public	6505.2	9338.4	10789.5	11619.1	13329.5	14164.0	13317.5
Private	na	na	443.9	777.9	1173.1	1909.9	2650.6
Total	6505.2	9338.4	11233.4	12397.0	14502.6	16073.8	15968.2
Share of Private	na	na	4.8	7.4	10.2	14.9	19.4
Total Loans Disbursement (in mil. Birr)							
Public	3338.1	4303.8	3588.3	3786.8	3274.9	2919.1	2551.1
Private	na	na	253.5	854.9	922.5	1176.7	1475.3
Total	3338.1	4303.8	3841.8	4641.7	4197.4	4095.8	4026.4
Share of Private	na	na	6.6	18.4	22.0	28.7	36.6
Total Loans Collections (in mil. Birr)							
Public	2263.0	3127.1	3318.8	3355.0	3339.7	2775.2	3243.5
Private	na	na	207.7	673.6	777.3	767.2	1055.7
Total	2263.0	3127.1	3526.5	4028.6	4117.0	3542.4	4299.2
Share of Private	na	na	5.9	16.7	18.9	21.7	24.6
Total Number of Commercials*	4	6	7	7	9	9	9
Public	3	3	3	3	3	3	3
Number of Branches	215	217	220	221	221	222	223
Private	1	3	4	4	6	6	6
Number of Branches	1	19	31	38	58	77	92
Total Number of Branches	216	236	251	259	279	299	315
Share of Private Banks	0.5	8.1	12.4	14.7	20.8	25.8	29.2

Source: National Bank of Ethiopia. * Commercial Banks include Development Bank of Ethiopia.
na= not available.

2. PROS AND CONS OF ALLOWING ENTRY OF FOREIGN BANKS: LESSONS FROM DIFFERENT COUNTRIES

2.1. An Overview

Recent years are characterized by an increased importance of trade liberalization in general and financial sector liberalization in particular. Many banking institutions have also become international to facilitate such liberalized international trade. As a result, both developed and developing countries have increasingly allowed entry of foreign banks into their banking system although the pattern of entry is not uniform. In Turkey, for instance, foreign trade significantly increased over the past two decades that required sophisticated financial services and hence foreign banks quickly entered the country where the number of foreign banks increased from 4 in 1980 to 23 in 1990 - a net entry of 19 (Cevdet Denizer 2000). But this figure declined to 17 in 1997 due to merger of some foreign banks with smaller Turkish banks (see Table 2.1).

Table 2.1: Trends in the Number of Foreign Banks in the Turkish Banking Sector

Year	1980	'81	'82	'83	'84	'85	'86	'87	'88	'89	'90	'91	'92	'93	'94	'95	'96	'97
Banks*																		
State-Owned	8	8	8	8	8	8	8	9	8	8	8	8	6	6	6	NA	5	4
Private	24	24	24	19	19	20	24	24	26	24	25	26	31	32	29	NA	34	38
Foreign	4	6	9	10	13	15	17	17	19	21	23	21	20	20	20	NA	17	17
Total	36	38	41	37	40	43	49	50	53	53	56	55	57	58	55	NA	56	59

Source: Cevdet Denizer 2000. N.A.=Not Available. All banks are commercial ones.

Foreign bank entry refers to a process by which foreign banks set up operations in a host country mainly either through opening up a branch or a subsidiary, and a bank is said to be foreign-owned if over 50% of its total assets are foreign-owned (George Clarke *et al.*, 2001).

Liberalizing trade in financial services is based on the premise that the gains from foreign entry by far outweigh the possible losses. The possible benefits include creating competitive pressure upon the domestic banks which thereby, leads to efficient and quality banking services; increasing know-how in the banking system; enhancing diffusion of technological progress and innovations in the banking industry and allowing faster economic growth. For instance, WTO (1997) and IMF Survey (2002) argued that nations with open financial sectors have experienced faster growth than those with closed regimes. WTO (1997) further indicated that the

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economic success of Hong Kong and Singapore has been enhanced by internationally oriented financial sector. In short, benefits of foreign entry to a host country can be summarized as:

1. Foreign banks may improve quality and availability of financial services in the domestic banking system through increasing bank competition and facilitating the use of modern banking skills and technology;
2. They may stimulate the development of the underlying banking supervisory and legal framework;
3. Foreign banks may enhance access of a host country to international capital; and
4. Foreign banks have positive implications on overall economic growth and stabilities.

In general, most recent literatures are in favor of opening domestic banking system to large, strong and competitive foreign banks.

However, although foreign entry has got these and other potential benefits to a host country, the following issues (or potential risks of foreign entry) should also be deeply assessed. First, foreign entry exposes the economy of a host country to economic shocks of the entrant's home country. The second issue is that the financial sector is a strategic sector in transmitting monetary policy to the whole economy and this sector is dominated by the banking sector in developing countries. But the role of foreign banks could be totally different from that of domestic banks in this context. The third issue, which is very important for developing nations is that foreign banks may provide less credit for certain market segments such as small and medium-sized enterprises (SMEs). The fourth one is the same sort of issue that traditionally applies to trade in non-financial services. That is, how much benefits of entry of foreign banks are really in the hands of the native people who have less bargaining power.

In a nutshell, allowing entry of foreign banks into the domestic banking industry has got its own benefits and costs which need proper assessment before opening up the domestic financial sector to foreign entry. That is, allowing foreign entry is a sort of mixed blessing.

In this area, a number of studies have been made in both developed and developing countries. The next part of this section will summarize the existing literatures on foreign entry by focusing on three basic questions:

1. What are the factors that attract foreign banks to a host country?
2. What are the benefits and costs of foreign entry?
3. What are the modes of entry and organizational forms?

2.2. Identifying Factors that Attract Foreign Banks to a Host Country

Many empirical studies have indicated that different factors attract entry of foreign banks to a host country. These factors include home-host country economic integration, market opportunities available in a host country and entry restrictions and other regulations (including tax treatment) a host country follows. Each factor will be discussed below.

2.2.1. Home-Host Country Economic Integration

According to many studies, there is a positive and significant correlation between foreign entry and the extent of economic integration between home and host countries. Studies by Hulman and McGee (1989), which dealt with activities of foreign banks from different countries in the U.S (from-many-to-one-host" and by Miller and Parkhe (1998), which analyzed activities of foreign banks from one country throughout the world ("from-one-to-many-host") are few examples of studies that discussed home-host economic integration as one of the factors that attract foreign entry (see in George Clarke *et al.*, 2001). In general, studies that focus on relationship between foreign entry and home-host country economic integration are frequently taken to support the claims that banks tend to follow their customers abroad.

This argument, however, criticized by many researchers on the basis that it is unclear whether capital flows in non-financial sectors exert a causal influence on the flow of banks' capital or the causation might run in opposite direction. Furthermore, Seth, Nolle and Mohantray (1998) quoted in George Clarke *et al.* (2001) criticized this argument by finding that banks from four of the six countries (Japan, Canada, the Netherlands and the UK) allocated most of their loans to non-home country borrowers for the period 1981-1992 and they concluded that the "follow the customer" hypothesis has a more limited applicability than previously speculated.

In developing countries this hypothesis might have even less applicability. Therefore, for these nations alternative hypotheses that explain entry of foreign banks are required.

2.2.2. Profit Opportunities in a Host Country

Many recent studies have argued that foreign banks are attracted by profitable opportunities in host countries. For the period 1988-95, Claessens, Dermirgüç-Kunt and Huizinga (1998) modeled foreign entry across 80 countries from both developed and developing countries. They found that foreign banks are attracted by profitable market environment (with lower taxes and higher economic growth). Focarelli and

Pozzolo (2000) who employed richer set of variables to control for host country's market profit opportunities also found that foreign entry is greater where expected rate of economic growth is higher and the banking system is, on average, less efficient. These authors concluded that foreign banks are more likely to enter host countries with better prospects for growth (see in George Clarke *et al.*, 2001).

Concerning efficiency and size of a host country's banking system, it is clear that foreign entry is greater where local banks have higher average costs, lower net interest margins and less charge-off (i.e., signalling an inefficient use of capital) and where average bank size is smaller, which is easier to acquire and there is greater opportunity to increase market share after the re-structuring. This is basically true in developing countries where local banks are inefficient and smaller in size. Thus, foreign banks are more likely to enter developing countries in order to exploit local profit opportunities. This can be witnessed from many developing nations such as Czech Republic, Mexico, Turkey and South Korea (George Clarke *et al.*, 2001).

These two hypotheses tell us that foreign banks enter developing countries for different reasons than they enter developed ones. More specifically, the "follow the customer" notion seems less important for developing countries than for developed ones.

2.2.3. A Host Country's Regulations

The effects of a host country's regulations and restrictions, which are aimed at protecting inefficient and "infant" domestic banks have straightforward implications on foreign entry. Focarelli and Pozzo1o (2000) found that foreign entry is higher in host countries with fewer regulatory restrictions on banking activities. This implies that foreign entry is negatively correlated with domestic regulations and restrictions. Moreover, cross-country studies indicated that countries with tighter restrictions on entry into banking system (whether for domestic or foreign banks) are associated with higher net interest margins and higher overhead costs implying inefficiency in the domestic banking system. Similarly, Goldberg and Grosse (1994) provided econometric evidence that foreign bank entry is higher in countries with less restrictive regulations on foreign banking activities. Likelihood occurrence of banking crisis in a host country is also considered as one of the limitations on foreign bank entry (see in George Clarke *et al.*, 2001).

Country case studies revealed that some developing countries such as Chile and Argentina Pursued " level-playing-fields" approaches restrictions on foreign entry while other countries such as Egypt and South Korea imposed special conditions on foreign bank participations (George Clarke *et al.*, 2001). In any case, initial conditions, which are less open approaches, have produced meagre benefits to a host country.

2.3. Implication on Overall Economy and Financial Sector: Benefits and Costs

A number of cross-country and case studies have been made on how foreign bank entry and/or presence affects overall economic activities in general and the financial sector in particular in a host country (positively and/or negatively).

2.3.1. Benefits of Allowing Foreign Entry

Theoretical and empirical literatures that favour opening up domestic banking sector to foreign banks based themselves on the traditional argument of higher competition, which was believed to improve efficiency in local banking system. According to WTO (1997) and George Manzano and Emilio Neri (2001), foreign bank entry forces domestic banks to reduce waste, improve management, credit allocation and service quality as well as variety. Moreover, costly rent-seeking activities are less feasible in an open environment. All these changes can reduce operational costs of providing financial services. Similarly, using an 80-country sample from both developed and developing countries, Claessens Dermirgüç-Kunt and Huizinga (1998) reported that foreign entry reduces non-interest income and overhead expenses of domestic banks. This finding implies that foreign bank entry leads to greater efficiency in the domestic banking system and provides positive welfare implications for a domestic economy. However, it holds true on average across a large group of countries and may not be supportive evidence for a particular country and hence country case study is required to support this conclusion.

The arguments of improving efficiency in domestic banking industry through allowing foreign entry have been confirmed in the particular country cases such as the Philippines (George Manzano and Emilio Neri 2001 and Angelo U. and Michael Sullivan 2001). They concluded that foreign competition compels domestic banks to be more efficient although the result is not satisfactory due to macro-economic policy impact. In Thailand (Sakulrat 2000; Sakulrat and Ramkishan 2001), China (Liu Tinghuan 2001), Argentina (George Clarke *et al.*, 2001), Colombia (Barajas, Steiner and Salafar 2000) and Turkey (Cevdet Denizer 2000), foreign entry also corresponds more generally with better operating efficiencies. The same findings were for India (Michael *et al.*, 2003; Sayuri 2002; and Talwar 2001) and for Tanzania (Adrian 2003 and Tadeo 2003). The notion of improving efficiency in domestic banking through competitive pressure from foreign entry has also been advocated by many other authors like Howard Chao (2001), Alberto Reyes (2001), Jammaz Al-Su-haimi (2001) and Pierre-Richard Agénor (2001) and Stijn Claessens *et al.*, (2002).

In short, the common finding of these authors for different countries is that foreign banks entry basically improves overall efficiency and competitiveness in the domestic banking system.

In the case of Colombia and Argentina, the authors also found that foreign banks did not equally compete against their domestic counterparts in every sector of the economy except in few sectors where they have comparative advantages. Their findings are consistent with the hypothesis that foreign banks enter specific areas of a host country where they have comparative advantages and put competitive pressure on domestic banks. More specifically, domestic banks with loan portfolios concentrated in manufacturing where foreign banks traditionally devoted a large part of their lending, tend to have lower net margins and profits while domestic banks involved in customer lending where foreign banks have not been heavily involved have higher net margins and profits. The basic idea here is that foreign entry exerts competitive pressure on all domestic banks but the pressure exerted is in specific lines of business and those lines may vary from country to country.

Turning to the case of the Philippines, foreign entry could be seen as pre- and post-1994. Prior to 1994, only four foreign banks were allowed to operate in the country, which were highly subject to restrictive regulations, i.e., they could not operate as universal banks nor engage in trust operations nor open new branches. But in 1994, Republic Act No. 7721, which called for the establishment of a maximum of 10 new foreign banks, was passed (George Manzano and Emilio Neri 2001).

In response to this legislation, 10 foreign banks entered the Philippines banking sector in 1995. About 53% of these foreign banks entered the country through establishing full branches. Mode of entry in 1995 and total number of branches are given in Table 2.2. At the end of the third quarter of 2000, a total of 21 foreign banks operated in the Philippines banking sector, which shows a considerable increase from the original 4 foreign banks in the country.

Although the objective of opening domestic banking sector to foreign entry is to deconcentrate the structure of the Philippines banking industry (total assets, loans and deposits) through intensive competition, the result was not as such significant. For instance, as Table 2.3 below indicates, the share of the top five banks in the total banking assets (all domestic commercial banks) was between 44-47 per cent in 1991-94 (prior to the new regulation), which was not changed significantly in 1995, after ten new foreign banks entered the banking sector of the country. In 1995, the share of these new foreign banks in the total assets was less than 2 per cent and it slightly increased to about 3 per cent in 1996, just before the Asian financial crisis. The share of the top five banks in the total assets declined by about 8 per cent whereas that of foreign banks (both new and old ones) picked up by around 54 per cent from nearly 13 per cent in 1996 to 20 per cent in 1997. By 1999, however, the share of foreign banks in the total assets declined below 15 per cent. The same is true in the case of concentration ratios of deposits and loans. This is mainly due to restrictions on branch expansion and tightened macro-economic policies. Thus, it is very important to pay attention to policy issues that revolve around "fair" pricing and providing "level-playing-fields" to all industry participants by removing various forms of

barriers. The authors concluded that the prevailing macro-economic policies and incentives matter in determining outcomes of liberalization measure in the country. This implies that allowing foreign entry alone (without appropriate macro-economic policies) doesn't lead to the expected benefits.

**Table 2.2: List of Foreign Banks Branches and Subsidiaries in Philippine
(As of 31 December 2000)**

Date of 1 st Entry in the Philippine s	Foreign Bank Branch /Subsidiary	Bank Classificatio n (universal, Commercial, etc)	Mode of Entry*	No. of Branch es**	Capital (P Million)***
6/22/45	Citibank, N.A.	Commercial	Original 4	5	2,567
7/23/45	Standard Chartered Bank	Commercial	Original 4	5	900
8/6/45	Hong Kong and Shan Banking Corp.	Universal	Original 4	4	1,350
4/15/47	Bank of America NT and SA	Commercial	Original 4	0	423
4/3/95	The Bank of Tokyo-Mitsubishi Ltd.	Commercial	c	0	720
6/1/95	Korea Exchange Bank	Commercial	c	0	257
6/30/95	The Fuji Bank Ltd.	Commercial	c	0	602
7/4/95	The International Commercial Bank of China	Commercial	c	2	389
7/10/95	ING Barings, Manila Branch	Universal	c	0	1,238
7/14/95	Deutsche Bank AG	Commercial	c	0	760
8/11/95	Bangkok Public Company Ltd.	Commercial	c	0	266
9/26/95	The Chase Manhattan Bank	Commercial	c	0	223
9/26/95	Chinatrust (Phils.) Commercial Bank Corp.	Commercial	a	16	2,616
10/2/95	ANZ Banking Group, Ltd.	Commercial	c	0	250
1/8/96	Banco Santander Philippines-Inc.	Commercial	b	0	2,505
1/29/96	Dao Heng Bank, Inc.	Commercial	b	13	2,495
11/6/97	Maybank Philippines, Inc.	Commercial	a	59	1,895
9/1/98	DBS Bank Philippines Inc. ¹	Commercial	a	20	2,244
9/7/99	ABN-AMRO Savings Bank Corp.	Thrift	a	24	857
11/26/99	United Overseas Bank Philippines	Commercial	a	96	2,184
12/29/00	HSBC Savings Bank Phils, Inc.	Thrift	a	14	671

Source: George Manzano and Emilio Neri Jr, 2001

* Mode of entry classified as follows:

- by acquiring, purchasing or owing up to 60% of the voting stock of an existing bank;
- by investing in up to 60% of the voting stock of a new banking subsidiary incorporated under Philippine laws; and
- by establishing branches with full branching authority.

** As of December 2000, exclusive of main branches of foreign banks and head offices of foreign bank subsidiaries.

*** Based on published statements as of September 27, 2000 for universal /commercial bank and as of June 26, 2000 for thrift banks.

¹) Formerly Bank of Southeast Asia, a locally incorporated bank that was acquired by development Bank of Singapore (DBS). Accordingly, DBS gave up its full bank branching authority originally granted on 28 November 1995.

In terms of performance indicators (such as net interest margin to total assets, overhead costs to total assets and net profit to total assets) averaged over 1990-95, the country is characterized by the highest overhead cost to total assets compared to both developing and developed countries implying less competitive pressure exerted on domestic banks due to macro-economic policy impact. Net interest margin to total assets was also the highest in the Philippines (4.2%) followed by Indonesia (3.5%) (see Table 2.4).

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In general, the Philippines' experience tells us that the impact of the chosen macro-economic policy regime may mask the competitive pressure that foreign banks could otherwise exert on the local banking system.

Table 2.3: Asset, Deposit and Loan Concentration Ratios (1991-2000Q3) (In Per cent)

Items	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Assets										
• Share of Top 5	43.55	44.34	44.1	46.96	45.71	44.04	36.43	37.95	42.69	49.58
• Share of Old FBs	13.75	11.56	12.09	10.01	9.03	9.8	12.92	8.72	9.44	10.38
• Share of New FBs					1.81	2.96	6.44	6.56	5.24	3.38
• Share of Total FBs					10.83	12.77	19.36	15.37	14.68	15.8
Deposits										
• Share of Top 5	48.44	47.94	48.68	49.99	49.1	49.74	44.11	44.28	51.8	53.62
• Share of Old FBs	7.82	8.03	7.74	7.58	5.61	5.12	6.55	7.08	8.12	9.63
• Share of New FBs					0.53	0.77	2.49	2.79	3.03	3.23
• Share of Total FBs					6.14	5.89	9.04	9.88	11.15	12.86
Loans										
• Share of Top 5	44.52	44.92	39.96	47.55	47.25	46.39	32.86	38.73	43.08	49.38
• Share of Old FBs	10.81	10.11	10.5	8.66	7.3	6.77	5.66	6.24	9.53	7.39
• Share of New FBs					1.31	3.7	4.81	5.31	4.48	5.3
• Share of Total FBs					8.61	10.47	10.47	11.55	14.01	12.69

Source: George Manzano and Emilio Neri 2001.

FBs refers to Foreign Banks.

Table 2.4: Performance Indicators of Banking Sector (In Per cent)

Countries	Years Over which Averaged (weighted Average)	Net Interest Margin/Total Assets	Overhead/ Total Assets	Net profit/total Assets
A. Developing				
Hong Kong	1990-95	1.9	1.5	1.7
Indonesia	1990-95	3.5	2.9	0.9
South Korea	1990-95	1.7	2.1	0.4
Malaysia	1990-95	2.4	1.6	0.9
Philippines	1990-95	4.2	4.4	2.0
Singapore	1990-95	1.9	1.3	1.1
Thailand	1990-95	3.1	2.0	1.1
India	1990-95	3.3	1.4	2.3
B. Developed				
Germany	1990-95	1.9	2.1	0.4
Japan	1990-95	1.4	1.1	0.2
U.S	1990-95	3.1	3.2	0.5

Source: George Manzano and Emilio Neri 2001.

As in most other developing economies, foreign banks in India have concentrated in large cities such as Delhi and Bombay. Since the 1991 economic reform, the number of foreign banks in the country increased from 24 in 1993 to 42 in 2000. Entry of banks into the Indian banking sector has improved efficiency and reduced profitability implying that foreign entry leads to greater efficiency and competitiveness in the domestic banking industry and hence positively affects the welfare of the bank customers (Michael *et al.*, 2003; Sayuri 2002; and Talwar 2001). Similarly, using 1165 banks across 47 countries, Ross (2003) found that restriction on foreign banks reduces efficiency.

Performance indicators of the banking sector in India revealed that non-performing loans (NPLs) have considerably declined mainly due to policy reforms and improved risk management imported by foreign banks (Sayuri 2002). As table 2.4 indicates, the ratio of overhead expenses to total assets was the lowest (1.4) next to Singapore (1.3) over the period 1990-95 implying efficiency in the banking sector of the country.

In Tanzania following the 1991 financial sector liberalization, private banks (both domestic and foreign) have been permitted to enter into the banking sector of the country. Accordingly, Standard Chartered Bank of UK limited, started operation in 1993. During the mid-2000 it became the fifth largest bank in Tanzania (in terms of total assets).

As of mid-2000, 55% of the total assets of the country's banking sector were accounted by foreign-owned banks. Similarly, of the six top financial institutions four were foreign-owned. Foreign banks in Tanzania have provided benefits such as improving efficiency through competitive pressure, improved risk management, enhancing overall economic growth and ensuring financial sector stability. As in the case of most developing countries, however, the unanswered question about foreign banks in the country is that they have channeled low credits to small and medium enterprises (Adrian 2003).

Entry of foreign banks also provides benefits that go beyond the standard efficiency-enhancing effects of increased competition. One of these benefits is that foreign banks may develop more robust and efficient domestic financial systems. For instance, they can spur improvements in institutional infrastructure by exerting pressure for improved regulation and supervision, corporate governance practices, disclosure rules and other international practices and standards (George Manzano and Emilio Neri 2001; WTO 1997; and Liu Tinghuan 2001). Moreover, foreign banks can bring to the local banks the financial strength of their home parent institutions and "import" the regulatory and supervisory services of their home-government including the lender-of-last-resort and deposit insurance functions (George Manzano and Emilio Neri 2001).

Furthermore, foreign entry can reap dynamic benefits such as speedier diffusion of

technical improvements and innovations in delivering financial services from home country to local banking sector that otherwise would have taken longer time in the absence of foreign entry and acquisition of consumer-marketing skills. These innovations include credit card facilities and management, ATMs and point of sales (POS) (George Manzano and Emilio Neri 2001; Sakulrat Montreevat 2000; Cevdet Denizer 2000; and WTO 1997).

Allowing foreign entry has a strong positive impact on overall economic growth and stability both in developed and developing countries. The economic success of Singapore, Hong Kong (China) and Indonesia has been highly facilitated through entry of foreign financial intuitions. Currently, in Hong Kong (China), Singapore, Switzerland and the U.S, financial services sector accounted for 7-13% of GDP. Similarly, in Ghana, financial sector liberalization in combination with appropriate macro-economic policies boosted growth in GDP from -1% in 1970s to over 5% in the 1983-90 periods (WTO 1997). Goldberg in George Clarke *et al.* (2001) also concluded that foreign entry is highly correlated with the U.S GDP growth. The secret behind such strong correlation between foreign entry and economic growth is that foreign banks lay strong foundation for financial stability, attract foreign direct investment (FDI) from their home countries and channel enough funds at lower costs to finance domestic projects (George Clarke *et al.*, 2001 and George Manzano and Emilio Neri 2001).

However, the massive capital inflows into a host country's economy without effective corporate governance and adequate supervisions and regulations in the banks and other financial institutions might cause financial crisis as was the case in Thailand (Tarisa Watanagase 2001) and Latin American countries such as Paraguay and Venezuela (Alicia Gracia-Herrero 1997). This implies that premature financial liberalization and opening up domestic banking to foreign entry might result in overall economic crisis in general and financial crisis in particular in a host county. Thus, experiences of these countries show that strong initial conditions in supervisory and regulatory framework as well as macro-economic environments are very crucial in this respect.

Concerning the stabilization role of foreign entry, especially during economic stagnations or crises, although there are opposing views, cross country and case studies have indicated that, on average, foreign banks have provided net benefits in terms of stability. According to George Clarke *et al.* (2001), when a host country faces economic crisis, foreign banks with internationally diversified assets portfolios may play a stabilization role. George Manzano and Emilio Neri (2001) also argued that during periods of economic crisis, the presence of foreign banks could provide diversified capital and funds for local credit and hence help in stabilizing its supply. Cross-country study made by Dermirgüç-Kunt, and Huizinga (1998) indicated that existence of foreign banks minimizes economic crisis of a host country. Case study of Goldberg (2001) quoted in George Clarke *et al.* (2001) found that U.S. banks

retrenched less credit following periods of crisis than foreign banks. In the case of Argentina, it was also found that foreign banks have provided greater loans than observed among domestic banks and hence foreign banks help in reducing the volatility of loan growth in the whole financial system of the country. In the Mexican case, Goldberg Doges and Kinney (2000) indicated that lending patterns of domestic banks tended to vary with GDP growth while that of foreign banks, which have low non-performing loans, were more responsive to market forces and provided more credits during economic crisis and hence foreign banks have a stabilizing impact in domestic financial system. As in the case of the U.S., Argentina and Mexico, foreign banks in the Philippines and Thailand, performed well during the Asian financial crisis (George Manzano and Emilio Neri 2001 and Angelo U. and Michael Sullivan 2001). This is due to the fact that foreign banks have a diversified source of capital and they are characterized by having more solid financial positions arising from larger basis of capital.

However, too much exposure to foreign banks from a single country (particularly from a country with high and frequent economic fluctuations and when the entrants do not hold diversified portfolios of assets) may increase instability in a host country. For instance, banking sectors in Latin America (typically Argentina) are highly exposed to economic fluctuations in Spain. Therefore, before allowing foreign entry, it is very important to pay attention to macro-economic conditions of home country as well as strength and efficiency of entering banks.

2.3.2. Costs of Allowing Foreign Entry

As there are many arguments in favour of foreign entry, there are a number of arguments against entry of foreign banks. Some of these arguments are based on the concept of "over competition". It has been feared that a massive influx of foreign banks could result in overaggressive competition, which would weaken domestic banks. In addition, "over competition" from foreign banks entry might enforce domestic banks to merge in order to remain competitive, which could create banks that are "too-big-to-fail" as monetary authorities fear that the failure of a single big bank could seriously affect financial markets (George Manzano and Emilio Neri 2001 and Pierre-Richard Agénor 2001). This problem could, however, be mitigated through enhanced prudential supervision.

Another argument against foreign entry is that on one hand foreign entry exposes a host country to economic shocks of the entrants' home countries (especially if home countries are subject to economic fluctuations and the entrants' banks lack diversified portfolios assets) and in the event of crisis, presence of foreign banks may provide an additional channel for capital flight and they withdraw abruptly from the local market in response to crisis and thus exacerbating the crisis on the other hand. That is, foreign banks may have a tendency to "cut and run" (George Manzano & Emilio Neri 2001).

Furthermore, it is expected that foreign banks tend to select the most lucrative market segments and/or they tend to channel less credit to certain market segments such as small and medium-sized enterprises (SMEs) in the domestic markets, which enforces domestic banks to serve more risk segments of the market (George Clarke *et al.*, 2001, George Manzano and Emilio Neri 2001 Angelo U. and Michael Sullivan 2001 and March 2002 Insight Issues). Then, since SMEs account for more than 50 per cent of employment in many developing countries, reduced access to credit for these firms could hurt overall economic performance. By asking 3,000 enterprises from 36 developing and transitional economies and controlling for a wide range of macro-economic, institutional and firm specific factors, George Clarke *et al.* (2002), however, found that existence of foreign banks improves financing conditions (both quantities and qualities) for enterprises of all sizes (i.e., including SMEs) through directly providing credit to SMEs (direct benefits) and through enforcing domestic banks to seek new market niches such as providing lending to SMEs (indirect benefit). Increased credit to SMEs by large foreign banks might be explained by recent changes in technology. For instance, Master (1997) quoted in George *et al.* (2002) argued that advances in credit scoring methodologies coupled with enhanced computer power and increased data availability might change the nature of small business lending. In short, empirical evidences on this topic yield mixed results and it needs further investigations in developing countries.

Other reasons based on an "infant" industry argument advocate that the banking industry should be regarded as a strategic industry and should be left at the hand of nationals (i.e., foreign entry is forbidden). It is strategic in the sense that directed lending by local banks, for example, have been employed as an instrument of industrial policy in a number of developing countries (George Manzano and Emilio Neri 2001).

In summary, a number of cross-country and case studies have indicated that benefits of allowing foreign entry such as improving efficiency in local banking sector through competitive pressure, promoting faster economic growth, facilitating diffusion of modern technology and innovation in the banking system, increasing know-how in banking services and ensuring overall economic and financial stability, on average, outweigh the possible potential risks including "over competition", exposure of host country's economy to the widespread shocks, profit remittances and less credit allocation to certain market segments such as small and medium-sized firms.

2.4. Modes of Entry and Organizational Forms

Since modes of entry and organizational forms foreign banks could take have important implications on the operations of domestic banks, host countries provided different incentives for foreign banks to adopt specific modes of entry and organizational forms. In the 1970s, for example, Egypt allowed foreign entry only in the form of joint ventures with the state. In the other countries like Argentina,

however, there is no strong incentive toward particular modes of entry and organizational form and yet not all banks make the same choice.

Among the various modes of entry, *de novo* and the acquisition of, or merger with, a domestic bank have been widely mentioned in the existing literatures. On the organizational forms the three common ones are as a branch, subsidiary or representative agent of the parent bank (George Clarke *et al.*, 2001). This section briefly summarizes the possible potential implications of these two modes of entry and three organizational forms.

Most recent empirical literatures have been in favour of merger and acquisition and the three organizational forms based on the notion of efficiencies and economies of scale in the host countries (particularly in developing countries). According to George Clarke *et al.* (2002), if weak and inefficient domestic banks are being purchased by, or merged with strong and efficient foreign banks from developed countries, this would bring benefits to the host country. Since domestic banks in developing countries are relatively inefficient, this might be expected to occur and hence becomes one of the opportunities to improve banking efficiency in these countries. Moreover, Merger and acquisition expose domestic banks to more recent technological changes that may have increased scale economies in producing financial services. It is noted that economies of scale may be greater for new services delivery methods such as Internet banking, phone centres and ATMS (Ibid. p. 26).

Mode of entry through merger or acquisition, however, is not without costs especially in the case of providing bank credit to small businesses. That is, the takeover of small domestic banks by larger foreign entrants might imply a reduction in credit to small firms.

As opposed to merger and acquisition, where large and efficient banks takeover small and inefficient domestic banks, *de novo* entry refers to formation and/or entry of new foreign banks in markets where mergers and acquisitions take place. Increased *de novo* entry basically benefits small-scale borrowers. In the case of U.S., for example, *de novo* banks tend to provide high share of loans to small businesses. *De novo* entrants, however, have faced difficulties in attracting deposits and finding profitable lending opportunities (George Clarke *et al.*, 2001). In short, empirical studies have been made on implications of this mode of entry in developed nations (e.g. the U.S.) and hence further studies should be made to examine its implications in developing countries.

Another aspect of considering implications of foreign entry on domestic banking system is the organizational forms in which entry occurs. As mentioned above, the three common organizational forms are a representative office or agency, a branch and/or a subsidiary. A representative office (or agency) is the easiest form of organization, which neither takes deposits nor makes loans. Most of the time it is

established to test possibility of further involvement in a host country. A branch, which is an integral part of a parent bank, however, can offer a wider range of services than agencies or representative offices. On the other hand, a subsidiary is permitted to engage in a broader range of financial services compared to both branch and representative office and in many countries, it has identical power as domestic banks and hence is regulated in the same manner (George Clarke *et al.*, 2001).

In the case of developing countries, since a representative office doesn't present full immersion of foreign entry, most of its potential benefits (or risks) for these nations will likely be derived from the two other organizational forms-the branch and the subsidiary.

3. BENEFITS AND COSTS OF FOREIGN BANK'S PARTICIPATION IN ETHIOPIA

As existing empirical and theoretical literatures summarized in section two have indicated, foreign bank's entry has got both negative and positive implications on the overall economy in general, and the financial sector in particular in a host country. These literatures have confirmed that the benefits outweigh the costs. Whether this is true or not in the case of Ethiopia, proper assessment is very important. Thus, this section tries to address issues from this point of view.

3.1. Possible Benefits of Permitting Foreign Banks' Entry into Ethiopia

As in the case of other developing countries such as the Philippines, Thailand, South Korea, Colombia and China, the entry of foreign banks into the Ethiopian banking system could possibly bring about some benefits. These possible benefits are briefly discussed below.

3.1.1. Improving Efficiency and Stability in the Domestic Banking Sector

Competitive pressure from foreign entry is one of the major ways that could improve efficiency in the local banking sector. That is, competition enforces domestic banks to reduce waste, improve management and quality and variety of services and become more efficient. Competition also reduces rent-seeking activities and minimizes the gap between lending and deposit rates and commissions premiums.

Entry of foreign banks can also reduce systemic risk for small financial markets, which are less able to absorb large shocks. Moreover, it can help to deepen and broaden financial markets by increasing the volume of transactions and the spectrum

of services, thus reducing volatility and the vulnerability to shocks.

In short, the gains from competition in the banking sector in terms of efficiency and the variety and quality of banking services as well as stability in the banking sector are likely to be greatly enhanced as a result of the entry of foreign banks into the domestic banking sector.

3.1.2. Enhancing Economic Growth and Stability

Empirical evidences from both developed and developing countries have witnessed that countries with well-developed and internationally oriented financial systems have registered faster economic growth. For instance, the economic success of Singapore has been greatly facilitated by internationally oriented financial services sector where its value-added share in GDP reached 13%. In the case of Ghana, economic growth also increased from -1% in the 1970s to over 5% in the 1983-90 (WTO 1997). Economies with such financial sectors are better able to adjust to economic shocks for they may provide more credits and diversified assets portfolio during economic crisis. Moreover, the existence of foreign banks increases international capital inflow through attracting foreign investors and channelling enough funds. Thus, the presence of foreign banks is crucial in the development of domestic and foreign trade and foreign direct investment. These benefits, however, significantly depend on the availability of investor friendly environment in the real sector of the economy. Cross and specific developing country experiences have indicated that foreign banks are primarily attracted by profit opportunities of a host-country.

3.1.3. Enhancing Foreign Capital Inflow

Foreign banks operating in developing economies are characterized by imbalance between assets and liabilities (i.e. total credits exceed total deposits). Foreign banks accordingly resort systematically to the local as well as the international inter-bank markets in as much as external financing is required to supplement local resources. The end results of foreign bank mechanisms to finance themselves from other subsidiaries within their group lead to an inflow of foreign currencies into the economy. Moreover, as indicated above, since foreign banks attract foreign direct investment (FDI) and channel more funds at lower costs, their presence may increase inflow of capital from their home countries and around the world.

3.1.4. Advancing Domestic Banking Services

As has been the case with the Philippines (George, Manzano and Emilio Neri 2001 and Thailand Sakulrat and Ramkishan 2001), foreign entry may lead to dynamic benefits like speeding up diffusion of technical improvements and innovations in delivering banking services in the country. Some of these innovative banking services include electronic fund transfers, automated teller machines (ATMs),

automated cleaning houses, point of sale systems, credit cards facilities, sophisticated computerization and modern management methods. Those innovations would lead to positive emulation by local banks by means of tailored training programs and by the process of "learning by doing".

3.1.5. Foreign Banks can Clear the Way for Ethiopian Banks to Go International

The domestic banks can gain a lot from the various rich experiences of foreign banks with regard to operation involving foreign exchange like foreign exchange lending, money transaction and sophisticated banking services. Such experiences are expected to build self-confidence for local banks to venture out and open branches abroad.

3.2. Possible Risks of Allowing Foreign Banks in Ethiopia

Allowing foreign banks' entry into the Ethiopian banking sector could cause certain damages to the economy in general and the banking sector in particular if supervisory and regulatory mechanisms are not there to closely monitor their operations. Since the main objective of these banks is profit maximization, they don't worry about issues like development of the country, income inequality, unemployment problem and poverty alleviation. Moreover, they may sometimes serve as conduits for the inward and outward movement of volatile short-term capital, which in turn could lead to serious domestic financial disruptions.

3.2.1. Foreign Bank Entry Could Reduce Market Share of Domestic Banks

In Ethiopia, currently, local as well as international organizations do business with domestic banks. But as soon as foreign banks enter the economy, it is highly probable that they attract most of these organizations due to their generally better quality of service and efficiency. This could further lead to a decline in the market share of domestic banks. For how long could such an effect stay in the banking sector depends on how fast other domestic banks react to this development.

3.2.2. Foreign Banks Presence Might Skew Credit Allocations

Since foreign banks allocate credit to large-scale industries, the manufacturing sector, real estate and service enterprises, small and medium-sized firms, cottage industries and risky sectors like the agricultural sector are ignored and/or left to domestic banks, which enforces the latter to serve more risky market segments. Opponents of foreign entry argued that in developing countries small and medium-sized enterprises account for over 50% of employment and hence less credit to these firms has an

important implication on the overall economy of a host country. By surveying about 3,000 enterprises in 36 developing and transitional economies, George Clarke *et al.* (2002), however, found that the presence of foreign banks improves financing conditions of all types of enterprises. Therefore, such potential risk is less likely to occur in the case of Ethiopia, too.

3.2.3. Capital and Deposit Outflow and BOP Problem

Normally, foreign banks may repatriate all the profits to the parent country. Moreover, if lending rates rise in the parent country and/or profit rates decline in the host country, foreign banks may withdraw their investment. During economic crisis, the presence of foreign banks may also provide an additional channel for further capital flight. The sum of all this could lead to massive capital outflow and hence aggravate BOP problem.

3.2.4. Possible Tax Discrimination

The tax variable reflects primarily the corporate income tax in the host country. Differences in this variable between domestic and foreign banks may reflect a different *de jure* tax treatment. More likely, any tax burden differences reflect differences in the activity mix and foreign banks' effort to shift profits worldwide so as to minimize their global tax bill. In short, foreign banks have more opportunities to shift taxable income abroad than domestic banks and this creates possible tax discrimination.

Most of these potential risks could be controlled and/or at least minimized through effective entry regulations and prudential supervision.

In any country, the regulation of the financial system begins at the market entry stage. It is internationally accepted that the regulation at the entry stage must be stringent to protect those entrants whose admission might be imprudent. Therefore, it is essential to set criteria to identify qualified and eligible entrants to the country. The criteria may include assessment of fitness and properness of owners and management of foreign entrants. More specifically, it is very crucial to look at experience, skill, knowledge and integrity of entrants.

The main concerns of prudential supervision should be on the safeness and soundness of the new entrants and their capacity to make positive contribution to the financial system of the country. Since both foreign and domestic banks are operating within the same economic environment, similarly supervisory policies, rules and regulations should be applied.

Currently, the practices of on-site examinations and off-site monitoring are carried out by the National Bank of Ethiopia. Once foreign banks are allowed to participate in

the country's banking sector, the full burden of supervision and regulation of all banks (foreign and indigenous) rest on the Supervision Department of the National Bank of Ethiopia. The basic problem is, however, shortage of adequately qualified, skilled and experienced staffs to achieve these responsibilities. Thus, before allowing foreign entry it is paramount to build the capacity of the Bank in general and that of staffs of the Supervision Department in particular.

4. CONCLUDING REMARKS AND POLICY IMPLICATIONS

The objective of this paper has been to examine the benefits and costs of allowing foreign banks' entry into the Ethiopian banking industry by summarizing experiences of different countries to draw lessons for the country. Cross-country and case studies have indicated that entry of foreign banks provides benefits to a host country in improving efficiencies in the local banking sector through intensive competitive pressures; ensuring overall economic and financial stability; enhancing diffusion of modern technologies and innovations in the banking system; increasing know-how in the banking services; and creating pressures on domestic banking authorities in host countries to enhance and eventually harmonize regulatory and supervisory procedures and standards to international best practice levels.

These benefits are, however, not without costs particularly in the short-run and at low level of economic development. The costs include "over competition", which in the short-run could cause domestic banks to fail, exposure of economies of host countries to economic shocks of home countries, high capital flight especially during economic crisis and less credit to small and medium-sized firms.

In short, according to many empirical studies, benefits of allowing foreign entry, on average, outweigh its risks.

This has important policy implications for Ethiopia. That is, as has been the case with the Philippines, Thailand, Colombia, China and other developing countries, foreign banks' participation in the Ethiopian banking sector could provide plethora of benefits that outweigh its possible costs. As to whether this is true or not, however, depends on a number of factors. First, modes of entry and organizational forms foreign banks could take have important implications and hence greatly matter in realizing the expected results. Second, since the regulations and supervisions the country has adopted are highly associated with entry of foreign banks and their operations as well as expansion (after entry), setting appropriate regulatory and supervisory mechanisms is also very important. Third, as in the case of the Philippines, chosen macro-economic policies could have straightforward implications on foreign bank entry and its operations in Ethiopia. Fourth, types of foreign banks that enter the country also highly affect the possible impact of foreign entry into the country's banking sector. According to George Clarke *et al.* (2001), strong, large and efficient

foreign banks from different home countries provide more benefits to host countries than weak, small and inefficient ones. Lastly, level of economic development and macro-economic environments also affect the likely benefits and costs of foreign banks' participation in the country and hence they should be closely assessed and looked into. In this regard, by using bank-level data for 48 countries for the period 1990-96, Robert Lensink and Niels Hermes (2002) found that at lower level of economic development and in weak macro-economic environments foreign bank entry is generally associated with less benefits. Such situations not only lead to low benefits but also cause banking crises in the host country (Dermirgüç-Kunt and E. Detragianche 1997). Moreover, foreign banks are less attracted to host countries with lower level of economic development and this issue also needs proper assessment before allowing foreign entry to the country's banking system.

Based on experiences of different countries summarized in this paper, it is recommendable to open the Ethiopian banking system to foreign banks. The entry should, however, be undertaken step-by-step as it was in the case of China, which set up four stages. In stage I, from late 1970s to early 1980s, China allowed foreign banks to open representative offices. In stage II, from 1980s to early 1990s, it permitted foreign banks to open operational branches in special economic zones. In stage III, during mid 1990s, improved regulations on opening up and supervising foreign banks were formally promulgated, allowing foreign banks to operate in 23 cities. The last stage started since 1996. In this stage foreign banks have been allowed to open branches all across China. Adopting this gradual approach has saved China from the problems observed in other Asian countries. As these stages reveal, still now, China doesn't allow foreign banks to open subsidiaries in the country. Such gradual approach is very important for Ethiopia to follow although the time framework might not necessarily be as long as in the case of China.

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