

**DEPARTMENT OF ACCOUNTING AND FINANCE FACULTY OF BUSINESS
AND ECONOMICS ADDIS ABABA UNIVERSITY ADDIS ABABA**

PROJECT TITLE:

Is Ethiopia Ready To Accept Foreign Banks?

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ACRONYMS

- AIB Awash International Bank
- BOA Bank of Abyssinia
- CBB Construction Bank of Ethiopia
- CBE Commercial Bank Of Ethiopia
- CBO Coperative Bank Of Oromia
- DB Dashen Bank
- DBE Development Bank Of Ethiopia
- LIB Lion International Bank
- FIs Financial Institutions
- GATS General Agreement on Trade in Services
- NBE National Bank Of Ethiopia
- NIB Nib International Bank
- SMEs Small and Medium Enterprises
- UB United Bank
- WGB Wegagen Bank
- ZB Zemen Bank

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Statement of Certification

This is to certify that Jemaneh Bayou has carried out his project work on the topic **“Is Ethiopia ready to accept foreign banks?”** under my supervision. In my opinion, this work qualifies for submission in partial fulfillment of the requirements for the award of Degree of Masters of Science in Accounting and Finance.

Signature _____

Abebe Yitayew (Asst.Professor)

Project Advisor

Statement of Declaration

I declare that this project work is my original work. It has not been submitted for any degree/Diploma in any University. I have undertaken it independently with the advice and suggestions of my advisor for the project, Ato Abebe Yitayew (Asst.Professor). In carrying out of the project work I have different sources and materials, which have been appropriately acknowledged.

Signature _____

Abreham Amanuel

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Abreham Amanuel
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Addis Ababa
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CHAPTER ONE

INTRODUCTION

A stable and well-functioning banking system is critical for economic growth and development and this makes the relationship between bank performance and development crucial. This relationship makes policy makers to take cautious actions towards developing the financial sectors. For the last two decades transition countries has been taking different structural reforms, which deals with a process of opening their financial service and domestic structural reform. These are interwoven processes, both aimed at developing an efficient and competitive financial system to facilitate economic growth.

The degree of financial liberalization and integration, in transition economies, has risen significantly for the past two decade's. Along with the expanded participation in The General Agreement on Trade in Services (GATS), policymakers have come to realize that the presence of foreign financial service providers can benefit the consumers, the financial industry through learning-by doing, and the economy through efficiency gains.

The financial sectors in Ethiopia, like other transition economies of its type, has undergone through different structural framework since 1991:-which pave the market based economical structure, in order to strength the sect oral development. This reform, for instance has brought private banks with full Ethiopian ownership to operate in the market, which leads to the expansion of the service through out the country.

In spite of the different reform made to the sectoral development, the liberalization towards foreign bank entry has been delayed for long, in Ethiopia. This has been made by the concern of the government among which the infant private domestic bank, and the doubt that entry by foreign banks will further skew credit allocation towards large-scale industrial, real estate and service enterprises are cited as constraint for financial sector liberalization.

Though, the above and some other factors are emphasized as restriction towards liberalizing the Ethiopian financial sectors, studies made in cross countries are confirming that the benefit of foreign banks entry outweighs over its risks. For example, Demirgüç-Kunt, Levine, and Min (1998) investigated the effects of foreign bank presence in 80 countries between 1988 and 1995. They found that liberalizing restrictions on foreign bank entry accelerated the efficiency of the domestic banking sector, and thereby contributed to long-run economic growth. Mattoo, Rathindran, and Subramanian (2006 cited in Barbara Peitsch et al p.3 2008) examined the effects of financial liberalization on per-capita GNP growth in 59 countries between 1990 and 1999 and found that openness in financial services had positive and significant effects on economic growth.

While the studies are showing that more than average of the weight to the benefit of opening the financial sector, the implementation has not yet made in the land of ours. On the other hand, the road towards WTO membership requested by the country recently raised the question of liberalizing the financial as well as telecom sectors. The former

sector is reserved for Ethiopian national, while the later is under state monopoly. With this situation, it perhaps is possible to liberalize the sector any time in order to tap the above benefit and to fulfill the membership condition.

In fact, accession process is based on negotiations: thus by committing itself to comply with the WTO regulations at fixed time in the future. However, experience of other countries shows that Ethiopia would be requested to open up the key service sectors for foreign competition if it joins the organization.

Along with the underlying factors, this chapter will assess the readiness factors towards opening the financial sector. Part 2, describe background information for the study which include the macro economic and financial sectors condition for the past 10 years and the statement of the problem defined in part 3. Following this part the other sections includes: Objectives of the study, Significance of the Study, Scope and limitation, research methodology which is presented in section 3, 4, 5 and 6 respectively. Finally, the organization of the paper is described with the last part.

1.1. Background of the study

Bank modernization in Ethiopia, which traces back the beginnings of 1990s, shows the participation of foreign ownership. The agreement was made between the emperor Menelik II and the representative of the National Bank of Egypt Mr.D. Mac gillivray (Belay Giday p.69 1987). This foreign participation continued until the beginning of 1974, by the time ownership was nationalized. From that time onwards ownership is restricted only to state-owned until the transition government comes to power and made a

reform that allowed the private ownership. However, the door has remained closed for foreign participant, the following section describe this facts.

1.1.1 History of Foreign Banks in Ethiopia

In Ethiopia, modern banking services was started in 1905 with the entry of Foreign-owned Bank of Abyssinia, which 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 in Feb. 16, 1905. It opened branch offices in some part of the country like Dire Dawa, Gore and Dessie and 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 Oreintale) and a new development bank (societe nationale d'Ethiope Pour le Development 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 Bank of Ethiopia- the first nationally owned bank on the African continent (NBE, 1999 and Alemayehu, 1999).

Foreign banking activities particularly that of Italian banks were expanded during the five years of the Italian occupation. Year of establishment (European year), name of bank are given in table 1 below

Table 1: Foreign Banks Operating in Ethiopia During the Italian Occupation

Year of Establishment (European Year)	Name of Bank
1914	✓ Banco di Italia
1914	✓ Banco di Roma
1939	✓ Banco di Napoli
1939	✓ Banco Nazionale (De's voro)
1939	✓ Casa de Creito...
1939	✓ Societe Nazionale di Ethiopia

Source: Alemayehu 1999 in Jonse 2002, p.3

After the Italian occupation of 1933-1941, banks of British 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 in Jonse,2002,P.3).

Monetary and Banking Proclamation No. 206 was introduced in 1963, which specifies the percentage share of foreign ownership in the financial sector. The basic idea of this proclamation is that a license to carry on banking business in Ethiopia was granted only to partnerships with Ethiopian nationality with at least the Ethiopian nationals have owned 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 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), two specialized banks (the Agricultural and Industrial Bank and Housing and Saving Bank), which currently 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 (Berhenu and Befakedu (1999/2000) in Jonse 2002 p.3).

Since economic reform of 1992 under the new government, these financial institutions have been re-organized so as to operate based on market-oriented policy framework. Moreover, 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.

The following table shows the ownership and name of private banks that emerged in to the market after the declaration of proclamation No.83/1994 and the Licensing and Supervision of Banking Business No.84/1994, investment policies.

Table 2. The expansion Private Banks in the market, after1991.

Years	Number of Domestic Banks Publicly Owned	Privately Owned	Name of newly established private bank
1991-1993	3*	0	
1994	3	1	✓ AIB
1995-1996	3	3	✓ DB , BOA
1997	3	4	✓ WGB
1998	3	5	✓ UB
1999-2004	3	6	✓ NIB
2005	3	7	✓ CBO
2006	3	7	
2007	3	8	✓ LIB
2008	3	9	✓ ZB

Source; NBE

***CBB, CBE and DBE**

After private banks allowed to operate in the market, they increased their number from 1 in 1994 to 9 in 2004. The increase in numbers has also brought competition in the number of branches expansion, and this reduced the population to bank branch ratio from 250,699 : 1 of 1998/99 to 156,128:1 in 2007/08, though, the number of population raised from 60.78 million in 1998/99 to 78.2million after 10 years. In this prospect the post 1991 period has shown progress compared to the Derge regime.

Table3. The number of total banks branch expansion and ratio to total population for the Period from 1998/99-2007/08.

YEAR	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08
Population (total), in millions	60.78	62.58	64.42	66.28	68.17	70.10	72.06	74.06	76.10	78.2
<i>Number of Bank Branches</i>	246	267	283	295	339	326	357	389	494	562
<i>Population :Bank Branch</i>	250,699 :1	237,828 :1	230,706.7 :1	227,119:1	203,834 :1	196,408:1	204,605:1	192,974:1	156,128 :1	156,128:1

Source: NBE

As shown in the table above, the expansion of private banks increased the service availability to the population. However, this number is still higher compared to other African countries. Moreover, there still exists specific shortcoming in the sector. First, following the expansion of the service there still exist very large excess liquidity in the sector, which calls for its effective management. Second, despite there expansion, the banks does not bring difference in profile. Third, regarding nonperforming loan it also exhibit unacceptable level of performance management. Finally, the level of IT use, poor development financing banks all calls for improvement in the sector

1.1.2. Macroeconomic performance and the Financial Sector in Ethiopia

During Period 1998/99-2007/08

Ethiopia enjoyed positive development of real GDP for the period during 1998-2008, except the fiscal year 2002/03. Comparing the first and second half of the decade, the recent five years, in terms of GDP, has shown significant progress an average growth of 11.78 per year. However, in both period agriculture constituted the lion share compared to other sectors contribution.

As shown in row. 4. of table 4. The financial sector contribution indicated a progress for the periods considered. The increase in assets of commercial to GDP ratio also confirms the above fact.

Considering the trade balance, there still exist a wider gape between the import and export of goods, which recently resulted in the increase in rate of foreign exchange. In turn, this resulted in the reduction of importable items from abroad. It is in this situation that, some big companies were observed to face shortage of foreign currency. However, there is a significant increase in the country foreign direct investment (FDI), which perhaps can resolve this currency shortage.

The deposit rate for money in the commercial banks has remained to be fixed by the regulatory body while the lending rate is fixed in the market. The regulatory body with its monetary policy is responsible to control the amount of money in circulation.

Is the current economic condition suitable for the domestic bank sector to be competitive enough with there foreign competitors? This is the question to be raised then. What remedy need to be made in order smoothen sect oral liberalization?

No	Year	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	Aver.
1	GDP at current market price(In Mn. Birr)	58,788.6	66,648.3	68,026.8	66,556.6	73,432.2	86,661.0	106,472.8	131,671.7	170,921.4	245,585.00	107,476.4
2	Real GDP Growth Rate in %	5.2	5.9	7.4	1.6	-2.1	11.7	12.6	11.5	11.5	11.6	7.7
3	Total Asset Of Commercial Banks *	19,474	23,959	26,493	28,338	32,110	38,125	47,254	54,089	67,572	82,004	41,942.00
4	GDP Contribution by Financial intermediation (In Mn Birr)	973,490	1,106,577	1,236,526	927,885	1,027,889	1,230,827	1,528,562	1,967,431	2,264,388	2,828,907	1,509,248.2
5	Total Asset of commercial Bank to Current GDP	0.33	0.36	0.39	0.43	0.44	0.44	0.44	0.41	0.40	0.33	0.40
6	Trade Balance	-959.9	-957.8	-957.3	-1,090.4	-1,207.1	-1,748.5	-2,482.2	-3,274.9	-3,787.3	-5,185.1	-2,165.05
	= Export of goods & service	913.9	984	979.1	982.7	1139.6	1519.4	1870.49	2156.89	2545.4	3128	1,621.95
	- Import of goods & service	1873.8	1959.8	1936.4	2073.1	2346.7	3,267.9	4352.72	5431.77	6332.7	8313.1	3,788.80
7	Exchange Rate (Birr/USD)	7.69	8.31	8.79	8.68	8.7091	8.6751	8.7110	9.0258	8.9570	9.5569	8.71
8	Foreign Direct Investment(IN Mn Birr)	1,380	1,627	2,923.3	1,474.1	3,368.8	7,205.22	15,405.12	19,980.06	46,948.95	92,248.78	19,256.13
9	Inflation General	4.3	5.4	-0.3	-10.6	10.9	7.3	6.1	10.6	15.8	25.3	7.4
10	Overall Budget Surplus/Deficit as % of GDP	-8.9	-11.5	-8.2	-10.9	-12.8	-7.6	-9.5	-8.8	-8.8	-6.97	-9.4

Table. 4. Selected Macro economic factors and financial sector contribution in Ethiopia, during the year 1998/99-2007/08

* Amount at the end of June 30

1.1.3. Financial sector reforms

The transition government introduced a market based economy since 1991. Among these reforms were measures to *decontrol prices and markets were taken in the financial sector. The following principal reforms in the financial sector were gradually introduced:

- The National Bank issued a directive, no. NBE/INT/7/98 to decontrol commercial banks' deposit and lending rates in January 1998. (NBE,1998a)
- The National Bank directive no IBM/02/98 set a framework for the conduct of inter-bank money market operations. (NBE,1998 b)
- The National Bank issued a directive no. SBB/24/99 that set a higher capital standard: a minimum capital requirement for new banks of birr 75 million.(NBE,1999)
- The establishment of discount window facilities for commercial banks through directive no. ERD/01/2001. (NBE, 2001).

*reform in Exchange rate, interest rate and trend in inflation are attached in the Annex I,

II ,III

2. Statement of the Problem

Financial Institutions (FIs) are very important in an economy .Their role is similar to that of blood arteries in the human body ,because FIs pump financial resource for economic growth from the depositor to where they are required (shamugan and bourke,1990cited in Barth et al.2004).Banks are one of the major FIs and are key providers of financial information to the economy .There is evidence that well-functioning banks accelerate economic growth while poorly functioning banks impede economic progress and exacerbate poverty.

As part of the financial sector, the banks contribute their part to the countries development. Many transition economies has been making different reform and liberalization of there financial sector in order to enhance the economical development. The recent relatively high economic growth achievement in Ethiopia is also a result relatively productivity of this sector. This to be true, private banks which started to evolve after the reform in 1994 has been contributing their prominent role towards the sect oral development.

Following the privatization process many new banks have been expanded to access the high demands of the market potential through out the country. The expansion as recently evidenced is started to be backed by the development in information technology; which result in networking of branches through LAN and introduction of electronic payment

system like ATM. Despite this fact, there still exists untapped market, which calls for the expansion of the service through out the country to foster the targeted economic growth.

In order to foster development in the financial sector as well as the economic growth, for the last two decades, transition countries have been calling foreign banks as their market participant. Most of this countries liberation of the financial sector follows the membership in WTO.

Nowadays, the road towards foreign bank liberalization for this land of ours is not solely supported by literature and experience of other country but also request made by the WTO member countries. It is to be recalled that, Ethiopia's membership issue to the WTO, has been raised since January 13, 2003. So the liberalization is made soon or later depending on the commitment to be made on the respond.

Whenever the liberalization made, the foreign banks comes with their two side sword of potential benefits and risks. For this, the country needs to be ready at all time to avoid the possible risks that may come as a result of the process. With this prospect, the paper assesses the current situation that brings domestic banks to the level playing field with their foreign competitors. In addition, the favorability of the current macroeconomic environment will be assessed.

3. Research question

The research attempts to address the following questions

- ✓ What are the benefit and risks of foreign banks?

- ✓ What will be the impact of foreign bank on general economy efficiency reform?
- ✓ What will be the impact of foreign banks on domestic banks efficiency reform?
- ✓ What will be the impact of foreign banks of performance of domestic banks sector?
- ✓ Does the existing macroeconomic environment suitable for domestic banks, if foreign banks allowed?
- ✓ What will be the sequence of liberalization to tap foreign banks benefit ?
- ✓ What will be the foreign banks mode of entry?

4. OBJECTIVES OF THE STUDY

4.1. General Objective

Many transition countries allowed foreign bank entry for the last two decade as result of agreement made on the WTO. As numerous studies identified, benefit of foreign banks operation in those countries has outweighed the risks. Ethiopia also applied for the WTO membership and the liberalization process becomes one of the questions raised by member countries. So, soon or later the openness of the financial sector will become inevitable, under the condition that, the countries long and strong desire to be a member.

With this current situation the purpose of the study will be to investigate the readiness factor for the domestic banks in order to make a level playing field with there foreign competitors. Hence, it aims to suggest for the possible remedies to be made before the financial sector liberalization. In this respect, it asses the potential impact of foreign bank entry in domestic banking efficiency and performance so that to forward the remedial actions.

4.2. Specific Objective

- ✓ To identify the potential benefit and challenges of foreign banks, if they are allowed to operate with the current situation.
- ✓ In order to assess the potential efficiency reform and performance effect of foreign banks, if allowed to operate in Ethiopia.
- ✓ To identify the macroeconomic factor that invites the presence of foreign banks.
- ✓ To trace the possible sequence of liberalization that smoothen the entry of foreign bank.
- ✓ To identify foreign bank mode of entry, if allowed in a land of ours.

5- Significance of the Study

Many transition countries, though the cause for the foreign bank entrance varies, while operating with foreign banks they left us there literature for further investigation. So in country like us, where there is no foreign bank, we deal with this literature to investigate the potential impact of their involvement in the sectoral participation.

In view of the above, studies have been done to see the prospect of foreign bank entry, the case in Ethiopia. Among this study, Jonse(2003) identified the potential benefit of allowing foreign bank in to the Ethiopia banking sector by setting appropriate regulatory and supervisory mechanisms. In his study, he summarized different cross-country and specific country case studies. Kokeb (2005) reinvestigated the same issue with data collected from survey respondents and came up with similar outcomes.

Currently, there is no full operating foreign bank operating in Ethiopia in the form of branch or subsidiary, however, there exist Commerz-bank, second largest bank in Germany, with its representative office. This perhaps is attributable to those previous studies.

So the latest study is made before four years and now the macro economic set up has changed which necessitates the issue to be raised with the current circumstances and information about the concern of foreign banks disclosed by Ethiopia policy makers. So, while dealing the following items as shown below the potential risk and benefit also needs to be reinvestigated to reveal the current conditions and needs.

However, this part is one issue to be raised in this study. So, the other important issues consist of the following;

- It will identify the compatibility of the macroeconomic situation, if foreign banks allowed to enter.
- It will identify possible impact of foreign banks on domestic banks efficiency.
- It will identify possible impact of foreign banks on domestic banks performance.
- It investigates the sequence of financial liberalization that will smoothen foreign bank entry.
- It tries to recommend appropriate mode of entry, if foreign banks allowed to operate in a land of ours.
- It assesses the possible remedial actions to be made, in order to minimize the possible adverse effect following foreign banks entry.

By providing the above-mentioned information it will help the policy makers as well as the stakeholder in the banks to prepare for possible remedial actions for foreign bank entry .In addition, it provides the possible precaution to be taken by domestic banks.

6-Scope and Limitation of the Study

Even though the research needs to incorporate different variables, the researcher scope is limited to liberalization of financial sector from prospective of employees in the financial institution with special focus on banking sector in terms of its impact on domestic banks efficiency and effect on performance. In addition, the study is limited only to banking sector and may not generalize the impact and readiness on financial sector in general. With respect to geographic location the study specifically focus on Addis Ababa branches of the sampled banks.

7- Research Methodology

7.1. Data source

As a methodology, the study uses both primary and secondary data sources. Primary source such as questioners were prepared and distributed to the samples which were selected from the bank at large. In the questioner both open and closed end questions were incorporated in order to get the desired information.

As a secondary data source, relevant document were reviewed, these include published and unpublished documents from public organization, journals, books, internet,

newspapers and magazines. These sources are expected to be significant source of the relevant information of the successful result of project.

7.2. Sampling

The population of the study is all the professional employees in the financial sectors with focus on banking industries. For this purpose convenience sampling technique was used to select those who fill the questionnaire. The sample size for the questioner was 100 individuals. Thus the sampling techniques used to secure respondents for the questionnaire was non-probabilistic sampling.

7.3. Data analysis

The study took the analysis of data that was both qualitative and quantitative in nature. Tabulation methods, Frequency distribution, description of facts based on some statistical analysis are the techniques that were used in the study to analyze and interpret the data. For the data to be collected through questionnaire: tabulation and frequency distribution will be used while descriptive quality analysis was performed on data collected thorough documents.

8-Organization of the Paper

This paper is organized into four chapters. The next section, Chapter two, is about review of related literature that discusses about what foreign banks is, pros and cons of financial sector liberalization, importantly efficiency , performance of foreign bank operation and sequence of liberalizations as well as experience of other country will be summarized. In

chapter three, data collected from survey will be analyzed and presented. Chapter four dealt with the conclusion and recommendation of the paper.

CHAPTER TWO

2.1 Introduction

As globalization advances, countries experience increasing pressure and incentives to seriously evaluate the internationalization of services - the opening of domestic service markets to international competition, and the growth of cross-border provisions. This pressure stems from the increased importance of services, generally, to economic growth and well-being; the complementarities of services to trade and capital flows; and the increased ability to transfer services across borders. Regional trade agreements and deliberations increasingly focus on services and there are multilateral negotiations in the General Agreement on Trade in Services (GATS). (Claessens and Jansen, 2000 p.3)

Financial services are an important part of this trend. Increasingly, countries recognize that finance is crucial for savings, efficient resource allocation and growth. A broad sample of empirical and analytical work in recent years has confirmed that a sound and efficient financial sector is essential to economic growth.

The financial sector is a “make-or-break” sector for many developing countries in firmly achieving economic growth -especially given the challenges that both industrial and developing countries have faced in building robust financial systems.

Different literature support the view that ,@foreign banks can help countries build more robust and efficient financial systems by introducing international practices and standards; by improving the quality, efficiency, and breadth of financial services; and by allowing ore stable sources of funds. Given the state of institutional development of many developing countries' financial systems, these benefits could be substantial.

However, foreign bank entry is not without risks especially if it is conducted in the absence of strengthening the institutional framework. The gains and costs of trade in financial services depend on many factors including the structural reforms in domestic financial sector, the regulatory framework as well as the sequencing of liberalization. (Nihal Bayraktar and Yan Wang 2005, p.3)

With the above view, the remainders of literatures organized as follows. Section 2 presents the literature review on structural and organizational difference between Foreign, Domestic, and Government Banks. Section 3 presents form of foreign bank entry. Section 4 discusses the benefit and risks of foreign banks. Section 5 presents Initial conditions to be made before foreign bank entry in order to reap the gain and minimize the potential Risks of the foreign banks entry. In the section 6, the sequence of liberalization is provided with three different conditions. Finally, Section 7 discusses the relationship between foreign bank entry and Domestic bank reform.

@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).

2.2 Structural and Organizational Differences between Foreign, Private Domestic, And Government Banks

The three dominant types of banks in emerging markets are government, private domestic, and foreign. The differences are important to document and analyze because the three types of banks differ in important ways in the structure of their incentives, organization, and regulation.(Atifu mian ,2003, p.2)

The main structural and organizational differences between the three types of banks are based on the identity of who owns the cash-flow and control rights of the banks. Private Domestic banks are privately owned and managed by domestic shareholders. This means that both cash flow rights and control rights rest with the domestic shareholders of the bank. Foreign banks are also privately owned and managed, but differ in a couple of critical ways with private domestic banks. First, the cash-flow and control rights rest with foreign rather than domestic shareholders. Second, unlike their local counterparts, foreign banks are typically part of a larger chain of multi-national banks spread in different parts of the world. This separates foreign banks from private domestic banks in terms of their hierarchical organizational design.The longer distance between shareholders (typically residing in the west), and bank managers (residing in emerging economies) for foreign banks implies that foreign banks have more layers of bureaucracy between top management and local bank managers. Government banks on the other hand are neither privately owned nor managed. The cash-flow rights (ownership) rest with the tax-payers and the control rights with government employees (bureaucrats) hired to run the bank.(Atifu mifan 2003 p. 24) the following section also summarize this ownership difference from atifu mifan ,2004,p.24-27)

The differences in the structural design mentioned above can lead to important real differences in the performance of banks. First, an obvious implication of private ownership is that incentives to maximize profits are high for foreign and private domestic banks, while being close to zero for government banks. For government banks such profit maximizing objectives are often replaced by other types of objectives such as political, “social” or corruption maximization.

Second within private banks, the hierarchical structure of foreign banks may give them a comparative disadvantage versus private domestic banks in utilizing “soft information”. As we have already pointed out, foreign banks due to their multi-national nature have a larger hierarchical structure than private domestic banks. Greater distance between ownership and management in the case of foreign banks implies that management is controlled from a distance through a system of well-documented hierarchy. Rules concerning do’s and don’ts are well-defined so that employees can be monitored and incentives even at an arm’s length relationship. Domestic banks on the other hand are more flexible in their organizational design. Since they are managed and controlled locally, they can afford a more decentralized system of governance where an individual manager is given more control and discretion. The basic theory concerning this idea is well laid out by Stein (2002) in a recent paper. As the paper argues, the fundamental constraint that a centralized and hierarchical structure like that of foreign banks imposes is that they have to rely on “hard information” in making lending decisions. In the context of banking, hard information includes a credible track record such as past sales, revenue, exports etc.

Domestic banks on the other hand have flatter organizational structures. This (keeping everything else constant) allows top management and ownership to give a lot more power in the hands of the local bank managers allowing them to use “soft information” in making lending decisions as well. “Soft information” is information that cannot be verified by anyone other than the person who produces it. The ability to use “soft information” by domestic banks implies that private domestic banks are more likely to successfully lend to “soft information” firms.

Should government banks be better at using soft information as well? The answer is likely to be no. First, with a lack of incentives it is not clear whether government banks would use any information at all. Second, even under the efficient government hypothesis, government banks could also be organizationally-constrained to rely on hard information. The reason is that formal checks and balances in a government organization can only work when punishments and rewards are based on credible or hard information.

The third implication of differences in the ownership structure of the three banks may be the strength of bank supervision. The strength of supervision of a bank depends both on the capacity of the regulatory authority to monitor the bank, and also on the internal incentives of a bank to be conservative. Foreign banks could have stricter monitoring than private domestic banks, since the home regulatory authority resides in a developed country, and this could be more effective in enforcing prudential regulations.

Even if domestic and foreign banks faced the same level of regulation, foreign banks may endogenously adopt more conservative banking policies than domestic banks. The reason is that foreign banks because of their world-wide reputation at stake could face a larger

cost of default in an emerging economy, compared to domestic banks. Another reason for a more prudent behavior by foreign banks can be understood in the context of the agency problem of bank owners trying to monitor the level of risk taken by their managers. Generally, Incentives must be their for moral hazard reasons. Foreign banks might be able to provide better incentives to managers through promises of promotion to better “global” positions that domestic banks cannot offer due to their limited scope in operations. On the other hand, government banks in the absence of cash-flow rights are likely to be the least tightly regulated.

2.3 Forms of Foreign Bank Entry

Each host country determines the types of foreign bank operations it will permit. Desired forms of entry may vary from bank to bank and from country to country, depending upon business-strategy considerations and host country-laws and banking structures.(Inwon song,2004,p. 4)

Banks initially extended their services abroad in order to assist their home-country customers with international transactions. With a growing understanding of foreign markets and a more developed network of relationships with local financial institutions, some banks subsequently increased the range of their operations by adding local customers. Following this pattern, foreign banks would first establish representative offices. At a later stage, they would open branches and, eventually, establish subsidiaries.

Today, the actual pattern of foreign bank entry depends on a wider range of factors. In particular, the profit opportunities in the destination market have become a key factor in

determining the pattern of foreign bank entry. As a result, forms of foreign participation have become more varied, including full acquisition, targeted purchases of specific activities, joint ventures, alliances with local banks, and outsourcing of administrative and financial services.

a) Representative offices : are generally prohibited from performing any banking operations. They do, however, offer opportunities for contracts with the parent bank and its clients concerning a variety of commercial and financial business that relates to the foreign market.

b) Foreign branch: is an overseas office of a bank incorporated in a foreign country and constitutes a higher level of commitment than a representative office. Foreign bank branches are typically involved in wholesale banking.

c) Bank subsidiaries: are separately incorporated from the parent bank, whose financial commitment to the subsidiary consists of the capital invested. Subsidiaries are usually involved in retail banking markets. However, in some countries such as the United Kingdom, subsidiaries are often involved in wholesale investment banking operations.

d) Establishing an affiliate relationship or participating in a joint venture: can be another way to engage in foreign expansion. This usually involves taking minority stakes in local entities, and the level of involvement in the management of the local banks by the foreign bank is normally low.

2.4 Benefits and Risks of foreign banks

2.4.1. The Relationship between Foreign Bank Presence and Domestic Bank Performance

The literature mentions several arguments why foreign bank presence (see, e.g., Cho, 1990; Stiglitz, 1994; Levine, 1996; Buch, 1997; Berger and Hannan, 1998 cited in Robert and Niels [no date], p. 3) may influence domestic bank performance.

The presence of foreign banks may stimulate domestic banks to reduce costs and increase efficiency of existing financial services through competition. In the presence of foreign banks domestic banks are pressured to improve the quality of their services in order to retain their market shares. This may improve the quality of existing financial services of domestic banks. In particular, foreign bank presence may put old-style banking practices under pressure. Moreover, increased competition may lead to lower interest rate margins and profits.

- Foreign bank presence may lead to positive spill-over effects.

As the entry of foreign banks includes FDI inflow into the host banking sector, FDI literature will next be discussed to explain the impact of foreign banks' entry on the banking sectors. Theorists who discuss the impact of FDI underscore the importance of inter-industry and intra-industry spillover effects. The extent of intra-industry spillover effects of FDI on technology transfer depends on a particular local firm's own ability to innovate and imitate (Glass and Saggi, 1998; Petit and Sanna-Randaccio(2000 cited in Uiboupin Janek, 2006 p.2)

It is also suggested that spill-over effects of foreign entry depend on how much the domestic and foreign banking market differ by their levels of development. This phenomenon is known as the “technology gap hypothesis” which suggests that the spillover effects from FDI to domestic firms will occur only if the technology gap is not overly large and if the country has a minimum required level of human capital (Borensztein et al 1998; Kokko 1994; Konings, (1999 cited Uiboupin Janek ,2006 p.2) . An overly large technology gap between the foreign enterprise and domestic firm will lead to the dominance of competition effects. Aitken and Harrison (1999 cited Uiboupin Janek ,2006 p.2) showed that the productivity of domestic firms was negatively affected by FDI in Venezuela, where the competition effect slightly dominated. The reason was that foreign firms were “market stealers” who forced the domestic firms to produce less, which led to an increase in the average cost.

Besides the quantity of knowledge transfer, it is important to consider the level of quality of the knowledge transfer. Glass and Saggi (1998 cited Uiboupin Janek ,2006 p.2) found in their general equilibrium model that host countries with a higher technology gap receive lower technological quality with FDI. The capability to imitate and accept technology transfer is known as “absorptive capacity”. Countries that are able to imitate more and have a more intensive level of local research and development (R&D) receive more high-quality technological FDI. Therefore their conclusion about policy is that host countries should enhance the imitation by supporting local R&D to receive high-quality FDI. (Uiboupin Janek, 2006 p.2)

The application of FDI literature into banking sector would mean that the transfer of know-how from parent bank to a subsidiary has both competition and spillover effects on

host banking sector. Foreign subsidiary that operates more effectively due to more modern banking technology taken over from mother banks forces other. There could also be spillover effects – domestic banks can learn from foreign banks. Thus the competition effect can work in two ways: either domestic banks have high absorptive capacity and become more effective (catch-up effect), or if the technology gap is too high domestic banks are unable to compete with foreign banks and foreign banks will easily increase their market shares (market-stealing effect). The technology transfer and local firms' reaction to foreign banks' entry therefore depend on the development of the financial sector. (Uiboupin Janek, 2006 p.2)

To trace the above fact lets begin with the introduction new financial services by foreign bank. The introduction of these services may stimulate domestic banks to also develop such new services, improving the efficiency of financial intermediation of the domestic financial system. Moreover, foreign banks may also introduce modern and more efficient banking techniques that are new to domestic banks. These modern banking techniques may be copied. Additionally, foreign banks may help to improve management of domestic banks, especially if foreign banks directly participate in the management of a domestic bank, for example in the case of joint-venture or a take-over. Foreign bank presence may also lead to improvements of bank regulation and supervision, since these banks may demand improved systems of regulation and supervision from the regulatory authorities in the recipient countries. This may contribute to improving the quality of banking operations of domestic banks. All these spill-over effects may contribute to more efficient domestic banking practices, which may help to reduce costs. (Robert and Niels [no date], p. 3)

Foreign banks may increase the quality of human capital in the domestic banking system in a number of ways. To begin with, if foreign banks import high-skilled bank managers to work in their foreign branches, local employees/bankers may learn from the practices of these foreign bank managers. Moreover, foreign banks may invest in training of local employees. Increasing the quality of available human capital for the domestic banking system may contribute to more efficient domestic banking practices, which may help to reduce costs. (Robert and Niels [no date], p. 4)

Foreign bank presence may also contribute to a reduced influence of the government on the domestic financial sector, which may reduce the importance of financial repression policies, such as interest rate controls, directed credit policies, etc.

Governments in many transition and developing economies have used (and sometimes still use) this kind of policies. Several studies have shown that such policies may reduce the efficiency of banks (Fry, (1995 cited Robert and Niels [no date], p. 4). Thus, by breaking the role of government in domestic financial markets, foreign bank presence may also contribute to improving the efficiency of domestic banks.

In addition, foreign bank presence may also lead to higher costs for domestic banks. Most importantly, domestic banks need to incur costs to keep up with the large, highly reputed, international banks. Thus, for instance, they may need to make costs to implement new services, improve the quality of existing services and operations, and implement new bank management techniques. Moreover, they may need to make costs first to upgrade their staff. Such costs need to be incurred, at least in the short run. In the longer run, costs of investments focused on implementing new services, improving the quality of existing

activities, improving management, and the upgrading of staff should contribute to overall cost reductions of domestic banks. (Cited Robert and Niels [no date], p. 4)

2.4.2. Foreign banks and domestic bank behaviour: empirical evidence

Empirical evidence with respect to the effects of foreign bank presence on domestic bank behaviour is scarce. Cho (1990 cited Robert and Niels [no date], p. 5) finds that foreign bank presence in Indonesia contributes to increased competition in the banking market. The most comprehensive study on the efficiency and competition effects of foreign bank presence is provided by Claessens, et al. (2001). Using a large data set containing individual bank accounting information of domestic banks in 80 countries for the period 1988-1995, they show that increased presence of foreign banks is associated with reductions of profitability, non-interest income and overall expenses of domestic banks. Apparently, the competitive pressure of foreign banks leads to positive efficiency effects at domestic banks. Moreover, they find that these efficiency effects occur as soon as foreign banks enter the market; they do not seem to depend on the market share of foreign banks. Their conclusion is that foreign bank presence enhances efficiency and improves the functioning of domestic banks.

Denizer (2000 cited Robert and Niels [no date], p. 5) analyses the effects foreign bank presence has on domestic banks in Turkey. His empirical results show that net interest rate margins, returns on assets and 6 overhead expenses of domestic banks decrease after foreign banks have entered the market. These findings support the idea that foreign banks put competitive pressure on the domestic banks in Turkey, despite the fact that these

foreign banks had a market share of only between 3.5 and 5 per cent during the period 1970-1997.

Konopielko (1999) concluded on the basis of postal survey conducted in the Czech Republic, Poland and Hungary that the direct benefits from entry are limited, and the indirect effects are mainly in the areas of corporate finances and foreign trade services. Kraft and Galac (2000) conducted a survey among 40 Croatian banks to test the effects of foreign entry mentioned above by Bonin et al 1998, concluding that it is hard to assess the spillover effects of good banking practice, but all the other positive effects mentioned by Bonin et al (1998) are present in Croatia. The negative effects are reported to be very mild, the only negative impact on domestic banks being some evidence of skilled labor flow from domestic to foreign banks (Kraft and Galac (2000) cited Uiboupin Janek 2006 p.4) .

Goldberg et al. (2000, cited Uiboupin Janek , 2006 p.4) suggest that foreign banks' presence increases credit growth at lower volatility. Nevertheless, they concluded, on the example of Mexico and Argentina, that a bank's health, not ownership per se, is an important factor for the growth, volatility and cyclicity of bank credit.

Cárdenas et al (2003 cited Uiboupin Janek, 2006 p.4) brings forth the following aspect of foreign banks' entry: foreign banks' entry leads to gains in the efficiency of the domestic market from new technologies, products and management techniques. Foreign banks may also stimulate competition on the local market. A study based on the Mexican market also showed that foreign banks' entry may be associated with higher market concentration.

Barajas, Salazar and Steiner (2000 cited Robert and Niels [no date], p. 6) carry out an analysis focusing on the Colombian banking system and using individual bank accounting data for the 1985-1998 period. Their study shows that foreign bank presence generally increases competition in the domestic banking system as evidenced by reduced intermediation spreads. Yet, foreign bank presence is also associated with a deterioration of reported loan quality among domestic banks. Moreover, administrative costs of domestic banks rise, possibly due to the fact that these banks have to upgrade their activities because of increased competitive pressure. Thus, in general foreign bank presence seems to be associated with an increase of costs for the domestic banking system of Colombia.

Lensink and Hermes (2003 cited Robert and Niels [no date], p. 6) focus on the short-term effects of foreign bank presence on domestic bank performance, using data of 990 banks for the period 1990-1996. This paper investigates the short-term effects of foreign bank entry on the behaviour of the domestic banking sector. They argue that these effects are dependent on the level of economic development of the host country and show that at lower levels of economic development foreign bank entry is generally associated with higher costs and margins for domestic banks. At higher levels of economic development the effects appear to be less clear: foreign bank entry is either associated with a fall of costs, profits and margins of domestic banks, or is not associated with changes in these domestic bank variables.

Enhanced foreign bank competition has forced lower commission fees in Turkey: for example, fees on letters of credit fell from 1.5 to 0.5%, and fees on letters of guarantee

fell from 4 TO 1 % following liberalization. Foreign banks can also directly improve banking services. In Spain, foreign banks pioneered the commercial paper market, the swap market , and spurred the boom in credit cards and ATMs. Also, in Philippines reaction by domestic banks following foreign bank entrance introduced new products like e-banking, telephone banking, and more extensive ATM networks, and followed foreign banks into an expansion of consumer credit, particularly through the use of credit cards. As a consequence they have also generally enjoyed lower profits. (L dos Santos Paulo(,2006, Levine 2001 p.11)

For Korea, Demirguc-Kunt et al.(1998 cited levine ,2001, p.11) present evidence that consistent with the view that easing restrictions on foreign banks stimulated improvements in Korea's domestic banking system. As barriers to foreign banks fell, Korean banks responded by boosting the quality of their loan portfolios and raising banking sector productivity. The aggressive response of removing impediments to foreign banks is indirect: the more competitive atmosphere supersedes rapid improvements in domestic bank efficiency, which positively influences economic development.

Furthermore, Lewis and Davis (1982) discuss three main economic functions of multinational banks. First, multinational banks mismatch assets and liabilities across currencies. The currency preferences of borrowers are not necessarily identical to those of savers, and multinational banks resolve these preferences. Second, multinational banks transform preferences across borders. Another function of foreign banks is to transform the maturity of deposits into the preferred maturity of borrowers. This is a core function of banks, and of most financial institutions (Williams 2002, p. 130 cited Uiboupin Janek, 2006 p.5).

2.4.3. Foreign banks, domestic bank performance and the level of financial development

Overall, the scarcely available empirical literature appears to conclude that foreign bank presence has effects on the performance of the domestic banking system through increased competition. It is less clear to what extent this also leads to improved efficiency, however: at least one study, i.e. the study on Colombia, reports increasing costs for banks after foreign bank entry. Another study shows that in the short-run, costs may go up, depending on the level of economic development of the recipient country (Lensink and Hermes, 2003). This seems to suggest that there may be a trade-off in terms of benefits and costs for domestic banks from foreign bank presence. (Lensink and Hermes, [no date] p.7)

By using bank level data of 982 banks in 48 countries for the period 1990-1996 Lensink and Hermes identified the effects of foreign bank presence on domestic bank performance depend on the level of financial development. More specifically, it reveals that: (1) Foreign bank presence is associated with higher costs and margins of domestic banks at low levels of financial development; and (2) Foreign bank presence is associated with falling costs and margins of domestic banks at higher levels of financial development.

The result interpreted as follows. At lower levels of financial development foreign bank presence has a strong effect on domestic banks in terms of spill-over of modern bank techniques and practices, since there is a large gap between the development of domestic and foreign banking. Yet, domestic banks need to make investments to implement these

techniques and practices. Therefore, costs rise. At the same time, since domestic banks still have a relatively strong market power in domestic financial markets due to the fact that these markets are rather segmented in less developed banking markets, they are able to raise interest rate margins and non-interest rate income to pay for the investments made. This may lead to an increase of income of banks. Although foreign bank presence may put competitive pressure on domestic banks, this effect is cancelled out. At higher levels of financial development spill-over are less important since the gap between domestic and foreign banks is smaller and banking markets are more competitive. Domestic banks are mainly confronted with the need to reduce costs and become more efficient in an effort to keep their market shares. Note that the above interpretation of the effects of foreign bank presence on domestic bank performance focuses on the short term. In the longer term the effects of implementing new bank services, techniques and practices may affect costs and margins negatively. (Lensink and Hermes, [no date])

In relation to the financial stability and market segmentation studies has also been investigated by different authors. Cross country evidences show that foreign banks stabilize the domestic credit through there global reach diversification and access to a lender of last resort. However, large and organizationally complex financial institutions with limited knowledge of the host country market, may find it difficult to lend to information-opaque small and medium firms. Supporting this facts (, 2005 p.134-136) summarize the facts as presented in section 2.4.4 and 2.4.5 as follows.

2.4.4. FOREIGN BANKS AND VOLATILITY

Do foreign-owned banks make domestic credit more stable or more volatile? An argument in favor of the idea that foreign-owned banks may stabilize domestic credit is

that internationally active banks from developed countries, through their global reach, diversification, and access to a lender of last resort in the source country, may have lower default risk and lower funding costs and be less prone to depositor runs. However, foreign banks tend to have lower exit costs than domestic banks, and hence they may be more sensitive to shocks that affect the host country and, in times of crisis, they may simply pack up and leave.

Furthermore, foreign banks may import shocks from their home countries.⁶ There is indeed some evidence that foreign-owned banks may transmit source country shocks to host countries. Peek and Rosengreen (2000), for instance, show that the explosion of the Japanese real estate and equity bubble in the early 1990s led to a contraction of credit of Japanese banks in the United States. Goldberg (2001) shows that the U.S. economic cycle strongly influences the international activities of banks headquartered in the United States. However, Goldberg (2001) shows that host country economic conditions do not influence the international activities of banks headquartered in the United States, contradicting the idea that foreign banks may leave in times of crisis.

Using a simple portfolio approach, Galindo, Micco, and Powell (2003) show that internationally diversified banks may be safer than domestic banks because the former can better take advantage of the law of large numbers to spread risk. However, when banks are more diversified across countries and suffer a shock to expected returns in the host country, they may cut back on local operations more rapidly than less diversified domestic banks. This result broadly suggests that the presence of international banks represents a trade-off for the host country. On the one hand, diversification of risk is likely to lead to safer banks and hence lower funding costs and, assuming the banking sector

is competitive, a lower cost of credit. In addition, foreign banks' access to international credit lines makes them less sensitive to shocks to domestic deposits. On the other hand, characteristics that make foreign-owned banks more secure, such as access to foreign business opportunities, make their lending more sensitive to aggregate demand shocks in the domestic market, and this may increase the procyclicality of domestic credit.

TABLE 5. OPPORTUNITY AND LIQUIDITY SHOCKS AND FOREIGN BANKS

Aggregate credit growth	Aggregate credit growth less than aggregate deposit growth	Aggregate credit growth greater than aggregate deposit growth
Negative	Negative opportunity shock	Deposit crunch
.	Credit growth of foreign banks < 0	Credit growth of foreign banks > 0
.	(Compared with domestic private banks)	(Compared with domestic private banks)
Positive	Positive liquidity shock	Positive opportunity shock
.	Credit growth of foreign banks < 0	Credit growth of foreign banks > 0 . . .
.	(Compared with domestic private banks)	(Compared with domestic private banks)

Source: IDB based on Galindo, Micco, and Powell (2003).

Following this line of reasoning, Galindo, Micco, and Powell (2003) focus on the following four states of the world (summarized in Table 5): (i) periods in which credit is decreasing and deposits are decreasing at a faster rate (deposit crunch); (ii) periods in which credit is decreasing and deposits are decreasing at a slower rate (negative opportunity shock); (iii) periods in which credit is growing and deposits are growing at a faster rate (positive liquidity shock); and (iv) periods in which credit is growing and deposits are growing at a slower rate (positive opportunity shock). They suggest that foreign bank credit should be higher than credit extended by domestic private banks

when lending is constrained by deposit availability (that is, during deposit crunches and positive opportunity shocks).

The evidence discussed in Micco and Panizza (2004a) is consistent with the idea that foreign bank credit tends to be less procyclical than credit extended by private domestic banks and that its stabilizing effect comes mainly from less volatile deposits. Furthermore, Galindo, Micco, and Powell (2003) show that foreign banks tend to stabilize credit during deposit crunches but amplify the credit cycles driven by changes in business opportunities in the economy. Anecdotal evidence also supports this view.

Evolution of foreign assets, measured as a share of total assets, for domestic and foreign banks in Chile during the second half of the 1990s(1994-2002) provides additional evidence in the above direction. After the fourth quarter of 1998, when the Chilean recession started, the banking sector as a whole increased its share of foreign assets, but the increase was substantially higher for foreign banks. During this period, total deposits in the Chilean banking system did not fall; therefore, it is plausible that the banks were mainly reacting to lower investment opportunities and that this reaction was larger for foreign banks. In the case of Colombia, instead, total deposits dropped by approximately 10 percent between the end of 1997 and 2001. During the same period, total credit collapsed by more than 30 percent, but the drop in credit was larger in domestic than in foreign banks, increasing the market share of the latter and suggesting that credit from foreign banks helped stabilize total deposits.

2.4.5. FOREIGN BANKS AND MARKET SEGMENTATION

One source of concern regarding increased foreign bank penetration in developing countries is that their presence might reduce access to credit for some segments of the market, in particular small and medium firms that depend on bank financing. Given that international banks are large and organizationally complex financial institutions with limited knowledge of the host country market, they may find it difficult to lend to information-opaque small and medium firms. In fact, small businesses tend to have exclusive dealings with a single bank with which they have developed an informal relationship that reduces asymmetric information. Large foreign banks could have difficulties developing these types of relationships.

Knowledge of the local culture may also be important. Evidence for Argentina shows that foreign-owned banks headquartered in other Latin American countries lend more to small and medium enterprises than foreign-owned banks with headquarters outside the region. This suggests that their superior knowledge of the culture and the economy may give them a comparative advantage (*vis-à-vis* other foreign-owned banks) in dealing with small firms (Berger, Klapper, and Udell 2001). It should be pointed out, however, that although large foreign banks are unlikely to replicate the lending method of small domestic banks, they can bring technological innovations (for example, new credit-scoring methodologies) that can foster credit for small and medium firms.

Empirical evidence of the impact of foreign banks on the amount of credit going to small businesses in developing countries is scarce and inconclusive. Some studies for Argentina show that foreign bank participation is associated with an increase in total lending, but also a reduction in the share of bank lending to small firms (from around 20 to 16 percent

of total lending in 1996 –98). Clarke and others (2000) analyze the behavior of foreign banks in four Latin American countries (Argentina, Chile, Colombia, and Peru) and find that foreign banks in these countries lend less to small businesses than private domestic banks do. However, these results are mostly driven by the behavior of small foreign banks (in all four countries, they lend less to small businesses than domestic banks of similar size do). The opposite is true for medium and large foreign institutions in Chile and Colombia, but not in Argentina and Peru.

In Argentina and Chile (the two countries where the financial sector developed most during the studied period), lending to small businesses by medium and large foreign banks grew faster than lending to this sector by domestic banks. The authors speculate that the institutional environments in Argentina and Chile allowed large foreign banks to use scoring methodologies to increase their lending to small and medium firms.

2.4.6. Foreign Bank entry and host country supervision

As the presence of foreign-owned banks grows it increases the complexity of the tasks facing supervisory authorities'. The challenges for emerging market supervisors include: (Inwon Song , 2004) summarizes the challenge to host country as follows:

- (i) Choosing of licensing policy and fitness and propriety test for management and owners of a complex holding company or investment funds;
- (ii) Effectively monitoring the local establishment of large international banks or complex financial institutions;
- (iii) Upgrading their supervisory capacity to oversee complicated financial products of foreign banks;

- (iv) Dealing with the issue of the parent bank support in case of difficulties of a branch or subsidiary in normal as well as systemic crisis situations;
- (v) Handling consolidated supervision in the event the market is heavily dependent on foreign banks;
- (vi) Effectively exchanging information with the home supervisors in the case of bank holding companies or other complex financial institutions;
- (vii) Dealing with increasing concentration in the banking system by foreign banks; and
- (viii) Improving the governance structure of complex international banking groups while, among other things enhancing the integrity standards in the financial markets.

These challenges should be resolved through more enhanced cooperation between home- and host-country supervisory authorities, as well as development of additional international best practices.

Mishkin (2005 cited in Linda S. Goldberg 2007, p.10) argues that financial globalization should be an important supporting force behind institutional reform. He contends that domestic institutions, facing competition from abroad, will seek new customers to stay in business. For lending to be profitable, domestic banks will require information to screen and monitor their customers. Better accounting standards and disclosure requirements, as well as a more efficiently managed legal system, will be consistent with continued domestic bank profitability. Foreign-owned banks will also be a constituency supporting these positive reforms because, as outsiders, they would not have access to the same information as their domestic competitors.

Numerous studies assert that financial sector FDI spurs improvements in bank supervision, with regulatory spillovers. The entry into emerging markets of foreign banks that are healthier than domestic banks implicitly allows a country to import stronger prudential regulation and increase the soundness of the local banking sector. In Argentina, Chile, and Colombia, for example, foreign banks have contributed to enhanced domestic financial stability by engaging in more aggressive risk management techniques ((Crystal, Dages, and Goldberg 2001). Calomiris and Powell (2001) cited Linda S. Goldberg 2007,p.10)) argue that Argentina's bank regulatory system in the late 1990s was one of the most successful among emerging market economies. Reliance on market discipline was viewed as playing an important role in prudential regulation by strengthening risk management among banks.

The transition to improved local supervision, however, might be bumpy. Major international banks may try to build market share by offering a variety of new financial products, including over-the-counter derivatives, structured notes, and equity swaps. These new derivative products can provide greater opportunities for hedging risks. Yet some new products may also be used to evade prudential regulations and take on excess risks, especially in countries with weak financial systems and underprepared supervisors (Garber 2000 cited in Linda S. Goldberg 2007,p.11). One clear implication is that local supervisors in emerging markets may have to invest in upgrading their skills in order to evaluate more efficiently the use and effects of new products. Other challenges for supervisors arise in the context of relationships with parent banks, and may depend on whether the foreign entry is accomplished through branches or subsidiaries.

Foreign bank entry also raises issues of competition policy within host-country banking systems. While the actual experiences of host countries have been researched extensively (see Bank for International Settlements [2001] and the volume's overview by Hawkins and Mihaljek), on average consolidation has occurred without deterioration of the competitiveness of a country's financial services industry (Gelos and Roldos (2002 cited in Linda S. Goldberg 2007,p.11)).

Another challenge can arise if a country's financial services industry becomes highly concentrated, in which case banks may exert monopolistic pricing tendencies more extensively. If foreign banks are among the few surviving banks, local regulators may be tempted to conclude that these banks bear specific responsibility for adverse outcomes. Yet in many cases foreign bank entry is part of a larger scale restructuring and recapitalization of the emerging market financial system. More concentrated market power may have occurred regardless of whether owners were foreign or domestic. Even with monopolistic pricing, there may be other benefits through scale economies and improved services that are by-products of consolidation. These issues challenge regulators to engage in careful cost-benefit analyses and policy reactions .

2.4.7. Summary of benefit and Risks of foreign banks

As shown above, there are several studies that analyze the effect of foreign banks' entry on the banking markets of transition economies. However, more intensive empirical research has only been undertaken in the 21st century. The studies in the 1990s were mainly descriptive or comparative (see Bonin et al (1998); Konopielko (1999); Metcalfe

(1999); Kraft and Galac (2000)). Bonin et al. (1998) brings out the following expected benefits and hazards from the entry of foreign banks to transition countries (see also Goldberg et al 2000; Doukas et al (1998 cited in Uiboupin Janek [no date], p.3) The main expected benefits summarized as follows;

- ✓ Introduction of new banking technology and financial innovations (it is relatively easy for foreign banks to introduce new products and services to the local market).
- ✓ Possible economies of scale and scope (foreign banks can help to encourage the consolidation of the banking system, they have knowledge and experience of other financial activities: insurance, brokerage and portfolio management Services).
- ✓ Improvement of the competitive environment (foreign banks spell potential competition to local banks).
- ✓ Development of financial markets (foreign banks' entry may help to deepen the inter-bank market and attract business from customers that would otherwise have gone to foreign banks in other countries).
- ✓ Improvement of the financial system's infrastructure (transfer of good banking practice and know-how, accounting, transparency, financial regulation, supervision and supervisory skills).
- ✓ Attracting foreign direct investments (the presence of foreign banks may increase the amount of funding available to domestic projects by facilitating capital inflows, and diversifying the capital and funding basis).

There are also several considerations of why foreign banks' entry may have an adverse influence on the banking sector in transition. The main arguments against foreign banks' entry are (see also Anderson and Chantal 1998 cited in Uiboupin Janek [no date], p.3):

- ✓ Fear of foreign control (control over the allocation of credit implies substantial economic power in any economy).
- ✓ Banking as an infant and special industry (this argument is a version of the general infant industry argument and banks are subject to various types of special protection due to their central role in the economy).
- ✓ Foreign banks may have different objectives (foreign banks may only be interested in promoting exports from the home country or in supporting projects undertaken by home country firms).
- ✓ Regulatory differences (supervisors of the host country lose regulatory control and if the home country has weak bank supervision, this may lead to unsound banking in the host country).

2.5 .Initial Conditions Can Be an Important Factor in Reaping Gains and Minimizing Potential Risks of Foreign banks Entry

Foreign banks perform better than domestic banks in developing countries and there profit too. The entry of these banks, will possible leads to reduction in domestic banks performance, what action needs to be made to tap the benefits and avoid the risks. Claessens Stijn and Jansen Marion, 2000, p.17-18 describes these remedial actions in relation to the cross-countries evidences as follows.

Financial liberalization can lead to a decline in profits of existing domestic banks, potentially leading to financial distress among individual domestic banks, especially in cases where the financial system is currently undercapitalized. Particular concerns mentioned in the liberalization of the financial sector are that foreign banks will operate only in very profitable market segments, will not service all sectors of the economy, and will have no commitment to the local market. As in other sectors, national security, cultural integrity, and other political economy arguments are sometimes used to demand barriers to foreign competition in the financial system. As stressed by Hindley, it should be clear, however, that the goal of authorities cannot be to maintain all financial institutions at all times: system stability rather than individual stability is what matters, and the exit of insolvent financial institutions is a necessary discipline.

Whether the extent to which profitability is affected is important enough to trigger systemic crises is doubtful, however. Experiences recounted suggest that the scope for new business opportunities (through both old and new services), as a result of various reforms, has most often allowed domestic financial firms to maintain profitability. Local financial firms have not necessarily been eliminated, and the demand for trained labor typically increases as foreign banks establish a domestic presence.

Experience suggests that fears of foreign domination, or reduction in the supply of financial services to certain segments of the economy, are largely unfounded. For the EU, for example, the effects on entry through new establishment were relatively small. In general, most of the beneficial effects of foreign entry appear to occur at low levels of foreign presence. There is also little evidence that foreign banks do not have a commitment to the local market. In New Zealand, for example, the financial system is

almost completely in the hand of foreigners, without any adverse effects on the stability of capital flows or, so far as is evident at present, on the access to financial services by various agents. There is little evidence, provided the playing field is level, that foreign financial banks would not be willing to provide financial services across a broad section of the economy, rather than operating in only the most profitable segments. In Argentina, for example, and many other Latin American countries, foreign banks play a large role in providing consumer services.

Nevertheless, if gaps in service are a problem, foreign banks, like domestic banks, can be encouraged to provide financial services in less profitable market segments through explicit subsidies or regulations. Experience also shows that countries which have experienced large shocks - triggered in part by macro and micro distortions - and have ended up with undercapitalized financial sector systems, can quickly benefit from opening up. Clarke et al. analyze the evolution of Argentina's banking sector in the nineties, in particular the period after the so-called Tequila crisis that struck the country at the end of 1994, and show the role foreign banks played in increasing capital. In Mexico and Venezuela, foreign banks have emerged as key players in efforts to recapitalize banks. In transition economies, cooperation between foreign and domestic banks has helped to improve the capacity of local institutions. Poland and Hungary (See the chapter by Kiraly et al.) are two examples where foreign banks brought in very useful know-how and capital.

Foreign bank liberalization can thus be harnessed to overcome up-front costs and minimize potential risks. This suggests that the overall benefits of liberalization can be positive quite quickly in some circumstances. Of course, competition from Foreign

Service providers must be fair - foreign entrants, like domestic banks, must demonstrate appropriate levels of skills, capital and reputation. Cooperation between national regulatory authorities is an obvious component of the review of foreign entrants' credentials.

Foreign bank liberalization will, however, put pressure on some domestic financial firms, the extent of which depends mostly on the degree of pre-existing structural problems. The asset quality of banks and other financial institutions is a major factor, with better capitalized domestic banks being able to maintain profitability more easily, as the case studies of Colombia, Hungary and Turkey show. A weak incentive framework, and undue domestic regulation, has made the adjustment of domestic financial firms, following opening up, much more difficult.

In some special cases, the potential systemic impact of the failure of some financial institutions - and the consequent lack of confidence in the stability of the overall financial system - suggests that special accompanying actions may be required to minimize the adjustment costs and potential risks of opening up, particularly when it comes to dealing with large non-performing loans. Some of the potential costs can be overcome, and potential risks can be minimized, through specific actions other than restricting entry by foreign financial firms, or cross-border provision of financial services. A currently undercapitalized financial system, for example, can be dealt with by facilitating financial restructuring of individual institutions, including liquidations, mergers and acquisitions (including those by foreign firms); and by significantly upgrading the regulatory and supervisory environment. Some of the country case studies in this case (Hungary, Portugal) give examples of actions taken by governments in this context.

2.6. The Sequence of Financial Liberalization

Whenever the information is imperfect and markets incomplete, which is to say always, and especially in developing countries, then the invisible hand works most imperfectly.... The market system requires clearly established property rights and the courts to enforce them; but often these are absent in developing countries. The market system requires competition and perfect information. But competition is limited and information is far from perfect – and well functioning competitive markets can't be established overnight.

Joseph Stiglitz, Nobel Laureate (2002)

Numerous literatures identified the order of financial liberalization by grouping it as stock market, capital account and financial liberalization, first. The effect of this sequence of liberalization on financial service performance and foreign banks entry has been investigated by different authors Bayraktar, Nihal., and Yan Wang (2004) summarizes this studies from (page 5-6) as follows.

There are many empirical and theoretical studies focusing on the order of financial liberalization. Kaminsky and Schmukler (2003) establish a comprehensive chronology of financial liberalization in 28 developed and emerging economies since 1973 @. Their study shows that while almost all G-7 countries liberalized their stock market first, European countries followed a mixed strategy. One fourth of them has deregulated their

Definition of Liberalization

The liberalization process is defined as follows by Kaminsky and Schmukler (2003).

- **Liberalization of domestic financial sector:** They evaluate the regulations on deposit interest rates, lending interest rates, allocation of credit, and foreign-currency deposits (Kaminsky and Schmukler, 2003 p.6).
- **Liberalization of capital account:** They evaluate the regulations on offshore borrowing by domestic financial institutions, offshore borrowing by non-financial corporations, multiple exchange rate markets, and controls on capital outflows (Kaminsky and Schmukler, 2003 p.6).
- **Liberalization of stock market:** They analyze the evolution of regulations on the acquisition of shares in the domestic stock market by foreigners, repatriation of capital, and repatriation of interest and dividends (Kaminsky and Schmukler, 2003 p.7).

domestic financial sector first but most of them liberalized their stock markets. Another result is that the liberalization of domestic financial markets was before the opening of capital accounts in developed countries.

They report that the order of liberalization was different in developing countries. While Latin American countries liberalized their domestic financial sectors first, East Asian countries implemented a mixed strategy. The experience of developed countries was much smoother compared to emerging market economies. Liberalization processes started in stock markets were the ones completed this process fastest. They indicate that the order of liberalization does not generally matter in terms of vulnerability to financial crisis. The exception is that crashes are more severe in developing economies if the capital account is liberalized first.

Claessens and Glaessner (1998) show that limits on foreign financial firms in Asia lead to slower institutional development and more costly financial services provision. There are important linkages between internationalization of financial services and two other financial reforms - domestic financial deregulation and capital account liberalization. If a domestic financial market is highly regulated, the opening of the domestic financial market may create problems to domestic firms since the system may be suffering from inefficiencies. The level of capital account liberalization may affect the benefits and costs of internationalization. They also point out that neither capital account liberalization nor the internalization of domestic financial services are prerequisite for each other; but some level of free capital mobility can be necessary for efficient internalization.

Dobson (2003) focuses on three dimensions of liberalization: domestic deregulation, market-opening, and capital account liberalization. She does not specify a sequence but

points out that a country undertaking domestic financial reforms and opening its market will be restricted at some point by continued capital account restrictions in terms of the provision of diverse and modern financial services. Those who have reformed and strengthened the domestic financial sector have met necessary preconditions to relaxing restrictions on the capital account and full internalization.

Johnston (1998) investigates the relationship between the financial sector reform and capital account liberalization. He shows that before opening capital accounts, the financial intermediaries need to be strengthened in order to guarantee the efficient use of capital inflows. Countries with weak financial systems may need time to develop financial institutions and markets, especially the banking sector, before liberalizing their capital account. Johnston, Darbar, and Echeverria (1997) point out three different views on the issue of sequencing financial liberalization.

One view claims that there are preconditions of capital liberalization such as macroeconomic stability and developing domestic financial institutions and markets before liberalizing the capital account. The second view claims that early capital account liberalization can play an important role in broader economic reforms. The last view is in between these first two views: capital account liberalization should be a part of the overall macroeconomic and structural reform. They indicate that the balance of benefits, costs, and risks of following one strategy rather than another may vary across countries.

McKinnon's (1991) book is a quite essential reference on the order of economic liberalization. He focuses on transition economies. Balancing the central government's finances is the first step that should be taken. The second stage is the opening of the domestic capital market. He argues that the last step should be the liberalization of the

foreign exchanges. The descriptive statistics indicate that there is no specific relationship between the level of economic development and openness to foreign banks. When the foreign bank share is investigated at the country level, it can be seen that this share changes a lot among countries.

When countries observed grouped according to their sequence of financial liberalization such as domestic financial markets first, stock market first, or capital account first, the result indicate that domestic banks' net interest margin, non-interest income, overhead costs, and loan loss reserve get the lowest values in the countries liberalized their stock market first. This indicates that competition is well-established in these countries. The highest values of non-interest income, overhead costs, and loan loss reserves are in the Asian and Latin American countries which liberalized their domestic financial markets first. Despite differences in the performance indicators among the groups, the foreign bank share does not change a lot. But it is considerably higher in the Asian and Latin American countries which liberalized either their stock market first or their capital accounts first.

The second set of results indicates that changes in the foreign bank share are not statistically significant in determining domestic banks' performance indicators when all countries are pooled together. Then, the countries are grouped according to their order of financial liberalization. The results indicate that efficiency gains from foreign bank entry, in terms of lower profit and costs are the highest in the countries which liberalized their stock market first. The weakest relationship between the performance indicators and the foreign bank share is obtained for the countries which liberalized their capital account first. (Bayraktar, Nihal., and Yan Wang,2005 p.6)

2.7. The Relationship between Foreign Bank Entry and Domestic Bank Reform

Financial liberalization and domestic reform can be mutually reinforcing. Experiences in numerous studies have shown that foreign bank entry affects in a positive way the soundness and stability of a country's financial system, and can lead to improvements in the prudential framework. Those case studies on the consequences of opening up show no instances where conflicts arose between the removal of barriers limiting entry, and regulation and prudential measures required for fiduciary or monetary policy concerns. Many countries have allowed the entry of foreign banks on a national treatment basis for long periods of time without any adverse effects on the conduct of monetary policy, or soundness of the financial system. (Claessens Stijn and Jansen Marion, 2000,p.16)

Furthermore, the case for prudential regulation and safeguards against economic turbulence is universally accepted, and is not an issue when it comes to internationalization. The GATS does not limit, in any way, the prudential measures authorities may wish to use “for the protection of investors, depositors, policy holders or persons whom a fiduciary duty is owed” or “to ensure the integrity and stability of the financial system” regardless of any other provision of GATS. (Claessens Stijn and Jansen Marion, 2000 p.16). Further, the GATS explicitly includes a balance of payments safeguard that allows the member to impose temporary restrictions that suspend its of commitments - on a nondiscriminatory basis - in the event of “serious balance of payments and external financial difficulties or the threat thereof.”

Nevertheless, as a consequence of incomplete legal frameworks, a lack of the skills needed for financial system supervision, and poor market discipline, developing country authorities, and other domestic agents, may find it difficult to monitor the more complex financial system resulting from opening up. In these cases, which likely call for improved domestic measures anyhow, it can be important to improve monitoring effectiveness by taking additional measures.

CHAPTER THREE

DATA ANALYSIS AND FINDING

In this part, it is tried to analyze the finding of the study. In the survey, a total number of one hundred (100) questioners have been distributed in the selected organization of FIs out of which sixty (65) are turned back and analyzed.

The survey embodied eight major sections:

- General information about the respondents
- Assessment of Domestic banks conditions
- Benefits and risks of foreign banks
 - Argument on Benefits of foreign banks
 - Argument on risks of foreign banks
 - Argument on risks of foreign bank identified by the policymakers
 - Comparison of benefits and risks of foreign banks
- The impact of foreign banks on the efficiency reform
 - Financial sector in general
 - Banking sector in particular
- The impact of foreign banks on Domestic banks performance
- Foreign banks and macroeconomic and social indicators
- Sequence of liberalization
- Remedial actions for the impact of foreign banks

Except for the general information about the respondents, reform required by foreign bank and some few inquiries, ordinary scaling of likert scaling is used. The scaling range from 5 to 1. This is made to require respondents indicate the degree of agreement or disagreement about the impact of foreign banks. The number are ranked from highest to lowest, where 5 refers to 'strongly agree' ,4 'agree' ,3 'neutral',2 'Disagree',and 1'Strongly Disagree'. This number attached in **Appendix V**.

Descriptive statistics associated with frequency distribution are used .These include;

- Measure of central tendency; Mean and Mode
- Measure of dispersion: Maximum, Minimum and Standard deviation

3.1. General information about the respondent

The purpose of the general information about respondent is to indicate the background of the respondent with regard to their sex, FIs in which they are working, experience in the institution, position in the organization and qualification about their education. The average experience of the employees in the institutions is found to be more than 10.39 years. This justify that the respondents have enough experience about the environment in the FIs-enough to be in a position to assess what is missing , what needs to be done to in order to bring domestic institution to be competitive with foreign banks ,if they are allowed to enter the market. The summery of the finding is depicted in Table 6.

Table 6. General information of the respondent

Attribute	Description	Frequency	Percent
	Bank	61	95.3
Financial institution of respondent	Insurance company	3	4.7
Sex	Total	64	100.0
	Male	53	82.8
	Female	11	17.2
	Total	64	100.0
Experience in FIs	< 5 year	11	17.2
	5 to 10 year	27	42.2
	11 to 20 years	16	25.0
	above 20 years	10	15.6
	Total	64	100.0
Position in the FIs	Manager	7	10.9
	Supervisor	25	39.1
	Clerk	6	9.4
	other	26	40.6
	Total	64	100.0
Educational Qualification	Master degree	4	6.3
	Bachelor Degree	53	82.8
	Diploma	6	9.4
	other	1	1.6
	Total	64	100.0

From the total sixty four (64) respondents 95% are employee in the banking sector and the rest 4.7% of the respondents are from insurance company. When we see in terms of gender the majority (82.8%) encompasses male respondents and only 17.2% of the total respondents are being Females.

Being considered in terms of the experience in the institution, the majority of the respondents (42.2%) fall under the age of 5 to 10 years, while 17.2% have been working less than 5 years. The rest of the respondents (40.6%) have been working in the institution more than 11 years. This implies that the respondents have enough experience in the financial institution, which enables them to identify the gap in the current condition to bring the domestic bank to the level playing field with their possible foreign competitors.

In terms organizational position only 6(9.4%) of the respondents identified to be clerks. The managers and supervisors constituted 10.9% and 39.1% of the total respondents. Position other than listed above includes the following;

Division Head (2)	Credit analyst (1)
Expert (1)	Bank inspectors (2)
Personal Bankers (1)	Bank officers (15)
Customer service officers (4)	

The above result indicate that the employees are working in different operation of the organization that helps to identify the impact of foreign banks and the possible remedial action to be made in order to safeguard from unfair competition for the financial sector particularly the banking industry, as a result of foreign banks entry.

3.2. Assessment of domestic bank current situations

The survey respondents were asked whether domestic banks are availing products to their customers or not? The result reveals that equal number of respondents have indicated an answer of yes and no. However the majority of the survey (60.9%) respondents identified, their views that domestic banks are not providing efficient service with current situation. Moreover, a highest number of respondents (82.5%) indicated that Working with foreign banks help domestic banks to be more dynamic.

Given the current macroeconomic condition, as majority of respondents demonstrate (67.2%), the foreign banks will be willing to enter the domestic market.(The finding summarized in Annex v)

TABLE 7. Benefits of foreign Banks

	Benefit of foreign banks	Total population	STATISTICS					
			Mean	Median	Mode	Std. Deviation	Minimum	Maximum
1	Introduce new financial innovation	63	4.5238	5	5	.75897	1.00	5.00
2	Accelerate the economies of scale	62	3.8226	4	4	.84007	2.00	5.00
3	Develop the financial market	62	4.1935	4	4	.67359	2.00	5.00
4	Improve the financial system infrastructure	63	4.1587	4	4	.84637	2.00	5.00
5	Attract foreign direct investment	63	4.2698	4	5	.76636	2.00	5.00

TABLE 8. Risks of Foreign banks from literature view point

	TOTAL SAMPLE		Mean	Median	Mode	Std. Deviation	Minimum	Maximum
	Valid	Missing	100	Valid	Missing	100	Valid	Missing
Foreign banks may reduce costs	61	3	3.4426	4.0000	4.00	1.04123	1.00	5.00
Domestic banking as an infant industry becomes less competitive	64	0	4.1875	5.0000	5.00	1.05221	1.00	5.00
Retain credit to small firms	59	5	3.2881	3.0000	3.00	.94779	1.00	5.00
Lack of domestic strong supervisory body	64	0	3.9844	4.0000	5.00	1.09098	2.00	5.00

Table 9. Risks of foreign banks from policymakers view point

Risks of foreign banks	TOTAL SAMPLE		Mean	Median	Mode	Std. Deviation	Minimum	Maximum
	Valid	Missing						
	100							
Lack of interest by foreign banks to mobilize domestic capital	63	1	3.4603	3.0000	3.00	1.10461	1.00	5.00
The infant industry agreement	63	1	4.0476	4.0000	4.00	.97432	1.00	5.00
Skew credit away from SME	61	3	3.6230	4.0000	4.00	.89748	2.00	5.00
limited supervisory position	63	1	3.9841	4.0000	5.00	1.02378	2.00	5.00
Fear of capital outflow	62	2	4.3226	5.0000	5.00	.90126	1.00	5.00

Table 10. Is the benefit outweighing the cost?

a) Literature point of view

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	yes	42	65.6	67.7	67.7
	no	20	31.3	32.3	100.0
	Total	62	96.9	100.0	
Missing	System	2	3.1		
Total		64	100.0		

b) Policy makers point of view

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	yes	34	53.1	56.7	56.7
	no	26	40.6	43.3	100.0
	Total	60	93.8	100.0	
Missing	System	4	6.3		
Total		64	100.0		

3.3. Benefit and Risks of Foreign banks

The theme of this section is to evaluate the benefit and risks of foreign banks from prospect of selected FIs employees. In order to accomplish this comparison the section is classified in to three parts. In the first part, respondents were asked to provide there ideas about the benefit of foreign banks, while the second part provides the respondents the benefits and risks of foreign banks upon which respondents were required to rate each aspect. Then these benefits and risks of foreign banks are compared and the comparative analysis provided in this parts.

The last part of this section deals with the concerns of foreign banks as cited by the policy makers. Many of this concern are also shared by the leadership of the private banks and the Ethiopian Bankers' Association. Employees in the financial institution were assessed to rank each of these views in order to identify their concerns with respect to the severity. Finally, respondent were request for the possible form of foreign bank entry, if the benefit outweigh with respect to the risks. The findings of this analysis are provided in (Table 7, 8, 9 and 9 the details attached in ANNEX V)

Overall, the respondents as indicated in table 7. The respondents identified the benefits of foreign banks more than the risk factors provided for them. The benefits outweigh the risks in both cases i.e. first with the risks identified from the literature as well as second with the risks identified by the policy makers.

Though the respondents give majority of there votes to the benefit of foreign banks there still exists a difference in ranking among the risk identified by the literature and the risk by policy makers. Interestingly the respondents agreed to all the risks identified by the policymakers moreover these risks are found to be more than the risks cited by

experience of other countries. These is due to the fact that when respondents requested to make comparison between the specified benefit and this two risk factors, 31.3% of the total respondents shows there concern to the risk from literature on the other hand 43.3% of total respondents rank the risk of policy makers.

3.3.1. The benefits of foreign banks provided by the respondents

The survey respondents identified different benefits of foreign banks among which the majority ranked introducing new product/service, efficiency reforms and enhancing competitive environment by the majority of the respondents.

3.3.2. Argument on Benefits of foreign banks

Countries which allows foreign banks to operate in there land faced the two sword sides and different literature evolve as consequence of the experience. From the literature identified the survey respondents are provided to rank the potential benefits of foreign bank, if allowed to operate in this land. Among the benefits the following are provided, introducing new financial service, accelerate the economies of scale, Develop the financial market, Improve the financial system infrastructure and attract foreign direct investment. The result described in table 7.

As can be seen in table 7 the respondents gave positive opinion, with a mean greater than 3, towards all the benefits of foreign banks as listed in the table. The most important benefit is introducing new financial innovation, while attracting foreign direct investment is the second,

developing the financial market is the third, improving the financial system infrastructure is the fourth and accelerating the economies of scale is the last.

a) Introduce new financial innovations

To assess the potential benefits of foreign banks the respondents were asked to rank the benefit in terms of introducing new financial innovation to the sector.

The respondents concurred at a mean of "4.52" with a standard deviation of "0.75897". More than 90% of the respondents agreed (60.9%) and strongly agreed (32.8%), while only 10% of the total respondents have different opinion from the majority out of which 1.6% gives a 'Neutral' views. This result indicates that, foreign banks if allowed to operate potentially bring new financial innovation to the financial market.

Describing the reason how foreign banks introduce new financial innovation? It is the relativity exposure of foreign banks with respect to domestic financial sector that gives the advantage to introduce new financial innovation. In addition, foreign bank with origin of developed countries could potentially bring the said benefits comparing the host country Ethiopia.

b) Accelerate the economies of scale

The survey respondents have pointed out that foreign bank with a scale of 'agreeably' will accelerate the economies of scale, if allowed to operate with current situations.

The mean of the respondents determined to be "3.82" with standard deviation of "0.84007". The majority of the respondents (62%) agreed (40.6%) and strongly agreed (21.9%) in the benefit of foreign banks in accelerating the economies of scale. 29.7% of the total respondents give there 'Neutral ' views. The rest 4.7% disagreed on the impact of foreign

banks in accelerating economies of scale. The output indicates that foreign banks will likely accelerate the economies of scale if allowed to operate with current conditions.

The above result is due to the fact that the entry of foreign banks as described in experience of other countries encourages the consolidation of the banking system, and they have knowledge and experience of other financial activities: insurance, brokerage and portfolio management Services which possible brings economies of scale to developing host country like Ethiopia.

c) Develop the financial market

The majority of the responses disclosed a scaling of "Agree" encompassing 41.3% of the total respondents. The next highest response 39.7% strongly agreed on the possible benefit. 14.3% of the respondents give there "Neutral" view. Only (4.8%) of the respondent's falls below neutral. The result indicates that foreign banks entry will possible bring a benefit of developing the financial market with mean of "4.19" and standard deviation of "0.67359".

Arguments of the above facts implies that foreign banks entry develop the financial market in away that help to deepen the inter-bank market and attract business from customers that would otherwise have gone to foreign banks in other countries. Moreover they potentially bring the necessary skilled human resources in this market from there home country.

d) Improve the financial system infrastructure

In this respect of foreign banks benefit the respondents are found to cluster at a number of "4" scaling with a standard deviation of "0.84637". The highest number of respondents (87.8%) agreed (56.5%) and strongly agreed (31.3%) on the impact of foreign bank in improving the sector infrastructure. Only 9.7% and 1.6% of the total respondents gave there "Neutral" and "disagree" scaling.

The result above clues that foreign bank with better practice and know-how spillover the trained to domestic financial sector to fill the gap in the development. Supporting this foreign banks could make improvement in the financial sector includes accounting and transparency, financial regulation, and through the increased presence such supporting agents as rating agencies, auditors, and credit bureaus.

e) Attracts foreign direct investment

Respondents were also asked to rank the benefit of foreign bank in terms of attracting foreign direct investment to Ethiopia, taking as a possible host country.

The majority of the respondents (84.1%) were found to be on a scaling above "Neutral" with a mean of "4.26" and mode of "5". 44.4% of the total respondents " Strongly agreed" and 39.7% agreed on the benefit of foreign bank in attracting foreign direct investment. On the other hand, while 9.7% of the respondents gave there "Neutral" views the rest 1.6% "Disagreed" on the possible benefits of foreign direct investment attraction as a result of foreign banks entry.

In the view of the above facts, foreign banks presence may increase the amount of funding available to domestic projects by facilitating capital inflows, and diversifying the

capital and funding basis. This perhaps could be utilized to potential venture businesses which currently unable to be financed due to the procedures in use. In anyways it avails the possible finance to the residents of host country. One more fact to notice is the availability of fund in terms of foreign currency, which increase the stock of foreign currency and in turn bust the importable items, upon which the government collect the tax on the imported items.

3.3.3. Argument on Risks of foreign banks

Foreign banks as stated earlier came up with the two sword side so the main theme of this section is to rank the risks of foreign banks from experience taken from other transition countries with respect to our current conditions, if allowed to operate.

The outcome of this survey revealed that foreign banks possibly come up with the similar risk factors identified in the literature. Among the different risk ranked by the respondents the impact on domestic banking sector in the view of infant industry argument are found to be the most series one, while lack of domestic strong supervisory in bringing stable finance environment is the second risk ranked. The risk as result of reducing cost and retaining credit to SME are ranked to be the third and fourth factors. This result point out that the area in which respondents are expecting the most action to be taken in order to bring the domestic banks to the level playing fields.(The findings are summarized in table 8 and details provided in ANNEX V)

a) Foreign banks may reduce costs

The respondents ranked the possible risk of foreign bank entry in reducing costs to the clients and so as to see the consequence in the banking sector. The respondents ranked the risk in third place after the other.

The majority of the respondents "agreed" (37.5%) and "strongly agreed" (14.1%) on the risk of reducing costs. 21.9% of the respondents give a "neutral" view, while the other similar number lay below this. The mean of the response is found to be "3.44" with a mode of "agree". This implies that entry of foreign banks possible leads to reduction in cost which implies an increase in competition to domestic market.

The above facts reasoned to be a foreign bank with strong finance and experience can possible reduce costs to domestic sector this is due to high economies of scale. In order to avoid the unfair competition domestic banks possible engage in a merger process. The risk become serious, as more and more banks bring themselves in to this process and finally they form a "too big too fail" bank. The failure of this single bank potentially disrupts the financial market. However, strong supervisory body possibly brings a solution to this serious problem.

b) Domestic banks as infant industry becomes less competitive

The possibility of less competitiveness as risk factor to domestic banking sector observed as serious risk factor in other transition countries and the applicability is also accepted by the respondents with mean of "4.18" and mode of "strongly agree" also ranked first among the risk factors. Nearly (90%) of the total respondents stood to be above "Neutral". On the other hand, 11% of the respondents lay below the average and the others (9.4%)

fails below "Neutral". The result highlight that if foreign banks allowed ,domestic bank face tough competition in line with the argument in a above it needs to be given emphasis.

The infant industry argument holds that an early market entry of foreign banks exposes to a risk that domestic financial institution would not be able to withstand increased competitive pressure and might even risk facing bankruptcy. Such a banking failure might have spillover effects on other banks and could possibly endanger stability of the financial market.

c) Retain credit to small firms

Literature in support of the above argument is often voiced against the entry of foreign banks. The argument discloses that entry of foreign banks is the fear that foreign banks choose only the best clients, leaving the domestic banking sector with pool of high risk enterprises. Foreign banks may emphasize lending for foreign trade and to large domestic companies. They are likely to have little interest or expertise in dealing with smaller domestic companies which may not satisfy international accounting standard.

The survey respondents are found to be in alien with the above argument with a mean of "3.28" and a mode of "3". The majority of the respondents (35.9%) give a neutral view while 37.5% and 18.8% of the total respondent found to be below and above the average point respectively. This result need close look at so possible remedial actions are required in order to avoid the possible risk concerning this enterprises.

d) Lack of domestic strong supervisory body

Literature identifies the positive relation between the factors for the need of strong supervisory body as foreign owned banks grow. In view of this respondents provided the

respondent requested to rank on the presence of strong supervisory body that can be able to regulate, if foreign banks allowed to operate.

The majority of the respondents (44.3%) of the total indicated to be above the average scale, while 34.4% gave "neutral" view. The remaining (18.7%) believe that there exist strong supervisory. The overall output indicates that the existing supervisory body is not able to regulate the financial sector with a mean of "3.98" and mode of "3" scaling under the current situation, if foreign banks allowed to operate.

3.3.4. Argument on risks of foreign bank identified by the policymakers

With special nature of the topic and the issue being hot it is found out to be important to consider the fact from risk of policy makers to fulfill the objectives of the paper. The argument spotted here under is the concerns of the Prime Minister and his government, as key stakeholders, many of which are shared by other stakeholders, including the leadership of the private banks and the Ethiopian Bankers' Association: (Cited in Kiyota et al, 2008 p.15-21).

In view of the above, respondents found to be in alien with all the risks identified by the policymakers. According to the views of the respondents the risks are ranked in away that fear of capital outflow identified to be the most important, followed by the infant industry argument and limited supervisory capacity found to be the second and third respectively. The skewing of credit away from SME is found to be the fourth and lack of interest by foreign banks to mobilize domestic capital is the last risk among the concerns by policy makers which is ranked by respondents.

One important fact to notice is that the risks provided by the literature and the risks provided by policy makers were having three similar items, that is risks concerned with infant industry argument, risk of credit allocation to SME and risk of limited supervisory body. It is not the similarity that matters, what matters is that when respondents requested to rank this risks the result demonstrate that though there is little bit difference in the mean of the items, however, interestingly the result reveals similar sequence in the risk identified, that is the infant industry argument, followed by limited supervisory capacity and skewing of credit away from SME. (The findings are summarized in table 9 and details provided in ANNEX V)

a) Lack of interest by foreign banks to mobilize domestic capital

The mean of the respondents is found to be "3.46" with a mode of "neutral" scaling. The majority of the respondents (45.3%) stood above average with a believe of "strongly agree"(21.9%) and "agree"(23.4%). 34.4% of the total population gave there "neutral" views about the risk of foreign bank in this regard. the rest 18.7% falls below average. The result indicates that there is risk of mobilizing domestic capital by foreign banks, if they are allowed to operate.

In line with the above facts domestic savings mobilization has been identified as an area of concern to Ethiopian officials, who have suggested that foreign banks would lend in their home or other foreign currencies and would not be interested in mobilizing domestic savings.

b) Infant industry argument

The infant industry arguments were inquired to the respondents to be ranked. The respondents found to be clustered at a mean of "4.04" with a mode of "4". The highest

number of respondents (79.4%) stood above average with a view of "agree" (42.9%) and "strongly agree" (36.5%). The remaining 11.1% gave there "neutral " (11.1%) views and the other (9.5%) falls below the average. As the output reveals there is a need to possible protect the infant financial sector, if foreign banks allowed to operate.

The concern of the policy maker, with respect to infant industry argument, has also got an emphasis by the survey respondents. The officials believe that the development of a viable domestic banking sector will be threatened by foreign banks, because they have more capital, more experience, and better reputations. They argue that the Ethiopian financial sector is too young and inexperienced to compete (the infant industry argument).

c) Skews credit away from small and medium enterprises

According to the survey result the mean of the respondents found to be "3.62" with a mode of "4". The majority of the respondents (60.5%) agreed (45.9%) and strongly agreed (14.8%) on the concern of policymakers. 26.2% of the respondents have given there "Neutral" views of the concern. On the other hand, the remaining 13.1% of the total respondents disagreed of the risk of foreign banks in skewing credit away from SME.

Emphasizing the concern the policy maker put there believe that entry by foreign banks will further skew credit allocation towards large-scale industrial, real estate and service enterprises (including trade) and away from agriculture, small-scale and cottage/micro enterprises (sectors which are the priorities for the government's development strategy). They contend that foreign banks will concentrate lending in major urban centers using

foreign funds, contributing little towards the development of rural banking. Furthermore, they contend that foreign banks will “cherry pick” the best companies and sectors.

d) Limited supervisory capacity

The survey disclosed that the highest number of the respondents (73%) stood above the average with a mean of "3.98" and mode of "4". 14.3% of the respondents give "neutral" view about the concern while the rest 12.7% lay below the average. The result indicate that this concern also like the others shared by the respondents, which requires a measure to improve the supervisory capacity, if foreign banks are allowed.

Stressing the capability of NBE bank supervision the officials strongly believed that "the authorities will be unable at present to regulate and supervise foreign banks effectively". So this is the area where the need for a lot to do rest, this is for the fact that a well organized regulatory body can be able to assess and stabilize the sector with necessary actions.

e) Fear of capital outflows

The concern for the capital flight as a consequence of foreign bank entry is found to be the most important risk with a mean of 4.32 and mode of " Strongly agree" scaling. The majority of the respondents (85.5%) stood above "Neutral". The remaining 9.7% gave "Neutral" scaling and the other 4.8% lay below "Neutral". The result indicates that the fear of capital flight is the most series effect that foreign banks impose, if currently allowed to operate.

In alien with the above result the officials also explains the fact that foreign banks may serve as conduits for the inward and outward flows of capital (e.g., through capital and

money-market transactions; credit operations; personal capital movements; etc.). This may cause foreign exchange and/or liquidity shortages, with potentially adverse effects on the country's capital account. The concern becomes more pronounced in view of the limited regulatory capacity of the central bank.

3.3.5. Comparison of Benefit of foreign banks and risks

In accordance with the survey result the comparison of benefit and risks of foreign banks reveals that in both cases the benefit of foreign banks outweigh its possible risks, if allowed to operate with current situations. In the first case, those who spotted the benefits of foreign banks listed from the literature outweigh the possible risks found to be 65.6% with the answer of "Yes" and the rest (34.4%) found to be with answer of "No". In the second case, respondents were provided with benefits from literature and the risks from policy makers concern. The result indicates similar output with difference in the number of respondents. In the latter case those who spotted "Yes" and "No" amounts to be 56.7% and 43.3%, respectively. (Table 10 and details attached in ANNEX V).

In both case the result found to be similar in that foreign banks benefit outweigh there risks, if they are allowed with current situation. In view of this, the respondents indicated " Joint venture" as the most appropriate mode of foreign banks entry with a vote of 37% from the total. Foreign bank branch is also suggested as second form of foreign banks entry with vote of 34%.

General Efficiency Reform	Total population		Mean	Median	Mode	Std. Deviation
	Valid	Missing	100	Valid	Missing	100
Improve financial regulation	63	1	3.7619	4.0000	4.00	1.02728
Introduce other financial activities	64	0	4.4531	4.0000	4.00	.56145
Attract foreign direct investment	64	0	4.3125	4.0000	4.00	.66368
Enhance the overall stability	62	2	3.0484	3.0000	3.00	.85751

Table 11. Efficiency reform to the general economy

EFFICIENCY REFORM TO BANKING SECTOR	Total respondents		Mean	Median	Mode	Std. Deviation	Minimum	Maximum
	Valid	Missing	100	Valid	Missing	100	Valid	Missing
Lower possible banking crises	63	1	2.7619	3.0000	3.00	.91077	1.00	5.00
Provide a more stable source of credit	63	1	3.4603	4.0000	4.00	.99718	1.00	5.00
Introduce new product and service	63	1	4.4921	4.0000	4.00	.50395	4.00	5.00
Enhance the competitive environment	63	1	4.1111	4.0000	4.00	.93517	1.00	5.00
Introduce a better supervision	64	0	3.6406	4.0000	4.00	.94897	1.00	5.00
Introduce a better disclosure	63	1	3.7143	4.0000	4.00	.72798	2.00	5.00
Transfer of know how	62	2	4.5323	5.0000	5.00	.56446	3.00	5.00
Transfer of good banking practice	63	1	4.4127	5.0000	5.00	.71018	2.00	5.00
Encourage consolidation of banking service	62	2	4.0323	4.0000	4.00	.74587	1.00	5.00

Table 12. Efficiency reform to banking sector

3.4. The impact of foreign banks on the efficiency reform

Numerous literature identifies the impact of foreign banks in bringing efficiency reform to domestic financial sector with particular emphasize the banking sector. This part of the study deals with the view of the respondents to the efficiency reform of domestic financial sector and particularly the banking sector, assuming that, if foreign banks allowed to operate in Ethiopia given the current macroeconomic conditions. (Table 11 and details attached in ANNEX V)

3.4.1. General financial sector efficiency reform

Respondents were asked to rate the possible efficiency reform to the overall economy, with respect to foreign bank entry. The result reveals that respondents gave affirmative response towards all the efficiency reforms to be made as a result of possible foreign banks entry. Moreover the result identifies introducing other financial activities as the most important among the efficiency reforms to the general economy. Attracting foreign direct investment and improving financial regulation ranked to be second and third, respectively. And enhancing the overall stability identified to be the last efficiency to be made to the general economy as a result of foreign bank entry with current situation.

In support of the above facts the argument state that the benefits of foreign bank entry in terms of improved financial service and regulation should outweigh potential costs (cream skinning, foreign market dominance, destabilizing rapid outflows of capital).

In addition, foreign banks with diversified source of capital and potentially higher capital possibly bring stability to the financial sector.

3.4.2. Foreign banks entry and domestic banks efficiency

In line with the literature stated the survey result found to be affirmative except the impact in lowering possible banking crises, which is found to be an adverse by the respondents.

From the efficiency reform provided for ranking transferring of know-how is found to be the most important while introducing new products and service is the second. Transferring of good banking practice and enhancing the competitive environment are ranked to be the third and the fourth, respectively. Based on there mean the reform in terms of providing a more stable source of credit found to be the last efficiency of banking sector. On the other hand lowering of possible banking crises lay below average, which implies the adverse effect of the entry.

a) Transfer of know-how

As the survey reveals that the majority of the respondents (96.8%) lay above "Neutral" with a mean of "4.41" and mode of "strongly agree" scaling. The result indicate that, if foreign banks allowed to operate there is higher expectation that the spillover effects that they will bring in developing capacity of human resource is the most required efficiency reform to domestic banking sector.

b) Introducing new products and services

The efficiency reform to be made in terms of introducing new products and services is ranked second by the respondents and there was no any neutral and opposing view towards this reform. So, all the respondents found to be in a scale of "agree" and "strongly

agree" with 100% vote. Nearly half of the total respondents agreed (50.8%) and disagreed (49.8%) on the impact of foreign bank in introducing new products and services.

The result above indicate that, following the spillover effect to develop the know-how the need to introduce products and services deserve an attention to bring efficiency reform in the sector.

c) Transfer of good banking practice

The respondents also ranked the transfer of banking practice as a result of foreign banks entry in the third place.

The mean of the result revealed to be "4.41" with mode of "strongly agree" scaling. The majority of the respondents (90%) agreed (38.1%) and strongly agreed (52.4%) on this efficiency reform. On the other hand 7.9% and 1.6% ranked "neutral" and "disagree" views respectively on the impact of foreign banks in bringing domestic efficiency reforms in terms of transferring of good banking practices.

This impact is more important to a transition country like Ethiopia where the level of technological development level and management skill is low compared to the developed once. Thus, the spillover in terms of this aspect initially leads to a rising costs, since domestic banks have to invest in such techniques and practices in order to implement them. And in latter period (in medium and long-term) this modern techniques and practices leads to reduction in cost charged to customers and increase the efficiency of the sector.

d) Enhance the competitive environment

Reform of domestic banking sector as possible consequence of foreign banks entry ranked in the fourth place by the respondents.

According to the survey result, the majority of the respondents (84.1%) have disclosed their view above "neutral". 9.5% disclosed their neutral view of the impact. Few (6.2%) opposed the possible efficiency reform. Overall the result indicates that foreign banks enhance the competitive environment with a mean of "4.11" and mode of "agree" scaling.

In the presence of foreign banks domestic banks pressured to improve the quality of their service so as to retain their market share. In particular, foreign banks presence may put old-style banking practice under pressure. Moreover, increased competition may lower interest rate margins and profits. As the competition stimulates domestic banks reduce costs, increase the efficiency and increase the diversity of financial service.

e) Encourage consolidation of banking service

Significant amount of bank consolidations during the past decade has been fostered by technological change and foreign banks entry in to emerging markets.

As the result in survey disclosed the majority of the respondents (85.5%) are found to be more than average, while 11.3% of the total give their "neutral" scaling. Only (3.2%) of the respondents give views less than average. The mean of the respondents found to be "4.03" with a mode of "agree" scaling.

Foreign bank with diversified resources benefits from economies of scale impose a cost reduction in the domestic sector. To resist this fact and to benefit from it, domestic banks form consolidation.

f) Introduce better disclosure

The respondents ranked in the six place among the efficiency reforms to be made by the domestic bank sectors as result of foreign banks entry.

The respondent identified to be with a mean of "3.71" and mode of "4". The majority of the respondents (68.2%) clustered on a scaling of "agree" and "strongly agree" with 58.7% and 9.5% respectively. 25.4% of the total respondent disclosed "neutral" scaling. Only 6.3% of the respondents lay below the neutral with a scaling of "disagree".

Foreign bank with a better technology and know-how assess the quality of feasible business and the technology provides better service in assessing risk business. So the domestic banks if not copy this practice they will left with the riskier business. In order to avoid the risks the domestic financial sectors uses better disclosure.

g) Introduce a better supervision

Respondent found to be a mode of "4" with mean of "3.64". The majority of the respondents scaled to be "agree" and "strongly agree" with 43.8% and 17.2%, respectively from the total survey respondents. 26.6% identified with "neutral" scaling. The rest 12.5% ranked to be less than the average.

In general, the respondent identified the current supervisory body is unable to regulate foreign banks and now they identify it the possibility to improve the supervisory body with spillover effect. In describing this effect (Goldberg Linda 2003 P.10) argues that

the entry in emerging market of foreign banks that are healthier than domestic banks implicitly allows a country to import stronger prudential regulation and increase the soundness of the local banking sector.

h) Provide a more stable source of credit

The survey also discovered the potential efficiency reform due to a stable source of credit. The majority of the respondents (54%) lay above the average scaling, while 15.5% fall below the average. 28.6% clustered on scaling of "Neutral". The mean of the response is found to be "3.46" with mode of "4". The output indicates foreign banks possibly bring stability in credit to domestic bank sectors.

In support of the above, studies argues that foreign banks create this by referring there parents for additional funding and have easier access to international markets. Thus domestic financial market will be less vulnerable to domestic shocks. There entry also reduces the influence of the government on the domestic sector, which may reduce the importance of direct credit policies. These spillover effects contribute to more efficient domestic banking practice, which may help to reduce costs.

i) Lowering possible banking crises

The respondents demonstrated this effect of foreign banks to be below "neutral" and this is the only factors shown to be the adverse effect.

The mean of the respondents determined to be "2.76" with mode of "Neutral" scaling. The majority of the respondents (41.3%) gave "Neutral" scaling. The next highest number (39.6%) fall below average while the remaining (19.1%) rest above average. This result indicates the possible adverse effect of foreign bank on domestic banking sector.

Considering the above adverse relation (**Daniel, B.C., and Jones, J.B., 2006**) developed a dynamic explanation, by modeling the evolution of a newly liberalized bank's opportunities and incentives to take on risk over time. The model reveals that even if a banking system is well-designed, in the sense of having good longrun properties, many countries will enjoy an initial period of rapid, low-risk growth and then enter a period with an elevated risk of banking crisis.

Thus immediately following liberalization, the capital stock is low, so that the marginal product of capital is high even when productivity is bad. The bank's foreign competitors lack experience with the emerging market and lend only at high interest rates. As a result, returns on bank loans are high, and even though banks choose high leverage, they face very little risk. Newly-liberalized banks enjoy high profits and see their net worth grow rapidly. But the capital stock grows as well, and becomes less productive. Foreign debt becomes cheaper as foreign lenders acquire more experience in the market. Loan interest rates begin to fall. It is at the point, when the bank's competitive advantage is still significant but declining, that risky behavior and banking crises are most likely. If the bank can weather this period, and retain a sufficiently large cost advantage over international lenders, it can enter a regime of more conservative behavior and lower risk.

What are the policy implications of the above study? So that to take possible remedial action. The model implies that a period of increased bankruptcy risk is inherent in an emerging economy's transition from repression to liberalization. The sensitivity analyses suggest that by reducing the upper bound on leverage, that is, by increasing the bank

capitalization requirement as in the Basle Accord, the risk of bankruptcy can be reduced. The sensitivity analyses also suggest the probability of a crisis can be reduced by capitalizing the bank prior to liberalization. Neither of these policies necessarily increases welfare. A higher capitalization requirement comes at the cost of lower returns for the bank, and capitalizing emerging banks diverts resources from other uses. Alternatively, postponing liberalization until banks have capitalized could reduce the pace of economic growth. The study however doesn't evaluate the best alternative. So choosing the remedial action for possible consequence remained to be answered with the possible remedies from respondents.

Effect on the performance	Total sample		Mean	Median	Mode	Std. Deviation	Minimum
	Valid	Missing	100	Valid	Missing	100	Valid
Foreign banks reduce local banks market share	64	0	4.3281	5.0000	5.00	.89184	2.00
Foreign banks attract qualified staffs	64	0	4.6563	5.0000	5.00	.54098	3.00
Foreign banks reduce local bank credibility	62	2	3.1613	3.0000	3.00	1.17618	1.00
Foreign banks reduce local bank total growth	64	0	3.5000	4.0000	4.00	1.06904	1.00
Foreign banks reduce local bank total growth asset	62	2	3.5323	4.0000	4.00	1.05143	1.00
Foreign banks reduce local banks lending growth	62	2	3.4839	4.0000	4.00	1.11240	1.00

Table 13 - Effect of foreign banks on performance of domestic banks

3.5. The impact of foreign banks on Domestic banks performance

This section investigates the potential impact of foreign bank in the performance of domestic banking sector. The selected performance measures were provided to respondents to rank. The summary are provided in (Table 13 and detail attached in ANNEX V)

As shown in the table 13. The most important impact on the performance of domestic banking sector identified to be foreign banks attracting qualified staffs, while reducing local banks market and reducing local bank total growth asset shown to be the second and third impacts, respectively. Reducing local bank total growth and lending growth found

to be the fourth and the fifth impact. Reducing the credibility of local banks identified to be the last.

The next section describes the analysis and arguments with three of the Items and the other are explained in terms of those items. The impact on market share, lending growth and qualified staffs are separately described while the analysis of the rest summarized and explained in terms of the interwoven effect of the performance.

a) Foreign banks entry and local banks market share

This is identified to be the most important impact to be focused ranked by the respondent in the first place. The majority respondents with mean of "4.32" lay above the average with total number of (84.1%) from the total. 9.4% and 6.3% of the respondents scaled to be "neutral" and "disagree". The result indicates that foreign banks possible reduce market share of local domestic banks.

b) Foreign banks reduce local banks lending growth

The survey result reveals that foreign banks potentially reduce the market share of the lending growth.

The majority of the respondents (62.9%) of the total population lays above the average point with a scale of "agree" (48.4%) and "strongly agree" (14.5%). 12.9% of the population gave a "neutral" view. The rest 24.2% of the total respondents indicated a scaling less than the average. These indicate that the foreign banks can exert reduction in market share of the loan growth of domestic banking sector.

In support of the result above (Lensink, R., and N. Hermes .[no date]) argue that the increased competition from foreign banks may weaken the loan portfolio of domestic banks, which may increase the need for high loan-loss provisioning i.e. higher costs. This

effect may be stronger for domestic banks of developing countries due to the smaller base of the loan portfolio of these banks, which means that they have fewer possibilities to diversify their risk as compared to banks in developing countries.

c) Foreign banks reduce local banks qualified staffs

As the survey indicated the respondents with a mean of "4.65" and standard deviation of 0.54098 clustered to scaling of "4". This effect is found to be the most important adverse effect that foreign banks possible bring to domestic banking sectors. The majority of the respondents encompassed on a scaling of "agree" (28.1%) and "strongly agree" (28.1%). The other found to be "Neutral" constituting 3.1% of the total population.

(Goldgerg, Linda 2007 p.6-7) explain the above fact by making a comparison between the FDI-in manufacturing sector and the investment in financial sector. The studies in FDI-in manufacturing industries link higher level of foreign direct investment to higher wages. The special nature of banks in intermediation mean that employment consequence of financial sector FDI may be broader, and more positive, than the consequences of FDI to the real economy.

o Other Performance impacts

This part of the analysis explains the performance effect of the survey response with respect to effect on credibility, total growth, and total growth asset. All this performance effect depend on the relative strength of domestic banks to there foreign competitors. However, a foreign banks with diversified financing source ,better management skill and risk management practices can possible impose the stated potential performance impacts.

3.6. Macroeconomic and social indicators

The relation between foreign banks investment and macroeconomic growth, and the stability of this growth is a central consideration as a host countries evaluate the trade-offs associated with foreign entry. (Detail attached in Annex V)

Respondents demonstrate there possible social and macroeconomic indicator that requires the entry of foreign banks to the financial sector. Among the factors provided respondents ranked the need for foreign exchange as an important factor. The need to speed up investment, to facilitate credit also ranked in the second and third place. The demand in reducing the population to bank ratio and to reduce the lending rate also spotted as the fourth and fifth stage.

In this part the survey also investigated whether or not the current macroeconomic environment is conducive to make the domestic banks competitive. The majority of the respondent (82.8%) of the total insisted that the current macroeconomic environment is not conducive to the domestic banks if foreign banks allowed to operate. Only (15.6%) of the total respondents agreed the suitability of the macroeconomic environment, if foreign banks are allowed.

Those who spotted the need to improve the macroeconomic environment stressed the need to loosen the policies of the regulatory body and the development in the infrastructure. From the infrastructure aspect the privatization of telecom suggested by many of the respondents, and reasoned out that this sector has great interlink for the development of banking technology ,which the customers are now a days highly demanding.

3.7. The sequence of liberalization

Literature after grouping countries based on their order of liberalization as liberalization of stock market, capital account and domestic financial institution to identify best efficiency as result of foreign banks entry. The highest efficiency gain observed in those countries which liberalize their stock market first and the lowest in the case of liberalizing their capital account first. The result indicated that competition is well established in those countries. (Detail attached in Annex V)

The respondents were also requested the possible form of liberalization to tap the benefit foreign banks, if they are allowed to enter the market. The result reveals that the majority of the respondents (37.5%) selected the liberalization of domestic financial sector first followed by liberalization of stock market and lastly the liberalization of capital account. The next highest number (21.9%) ranked liberalization of financial sector followed by capital account and stock market.

As the above result indicate majority of the respondent agree the liberalization of the financial sector precedes the others.

3.8. Remedial action to the possible impact of foreign banks

This section aims to collect suggestion of the respondent with respect to each of the reform that are required to make the domestic bank sectors to be in the level playing field if foreign banks allowed to operate with current conditions. The major issues supposed to facilitate efficiency of the sector are provided to the respondents. The findings are summarized in ANNEX V)

The respondent give a vote to all the reform provided. The need to upgrade the technological level of domestic banking sector ranked by majority of respondent (95%) of the total respondent indicated the need ,followed by the need to upgrady the supervisory body with (85%) of total vote. The need to upgrade the knowledge and skills of the staff voted by 69.5%, while the privatization of banks suggested by (64.5%) of total respondents. In genera, the survey indicate that the reform to be made need to incorporate the aforementioned suggestions.

In view of the above points the following section includes the suggestion cited with respect to each reform.

a) Reform to supervisory body

The respondents pointed out the necessary remedial actions to be made in order to restructure the supervisory body without which the operation of the foreign banks becomes risky. The restructure of this body as the respondents point out, starts with building the capacity of the central bank. The general remedies then cited as follow.

- The staffs in the supervision must get enough experience taken from other countries, which have created well and stable environment with the foreign banks experience.
- Empower the regulatory capacity of the supervisory body.
- The staffs need to see exposure visits with other countries.
- The supervisory body need to staff experts and also maintain these staffs.
- The supervisory need also to create possible actions that create efficiency in the sector like merging the activities of the banks.

- There is a need to redesign the strategies of the supervisory in order to meet the demand for this dynamic environment.

b) Remedial action towards Technological development

The respondents demonstrated their ideas that the development of the domestic bank is an important step towards foreign banks entry. In revealing the facts, they also insisted the possible liberalization of the telecom sector without which the feasibility of the stated objective has been hesitated.

In relation to the remedies to be made to the sector reform respondent insisted the following points.

- The ongoing study on national payment system should be streamlined for the application of modern and internationally accepted payment system.
- Latest technology should be adopted by the banks.
- Government need to encourage innovative banks or banks who enter the market with innovative banking technology. In away that, those with innovative system has to get tax free or less taxation.
- The banks need to install software that enables them to manage deposits, loans and payment process.
- The system need to be networked not only with the branches but also with the national bank of Ethiopia upon which the supervisory body able to monitor the status of the banks.

- The need for the supervisory body to be able to issue policies and law related with the electronic payment system also insisted by the respondents.
- Associated with this fact, the need to update the human resources with the current technology also cited as possible remedy.

c) Reform in human resource

Following the possible foreign banks entry the respondent's demonstrate the need to increase the stocks of the staffs' knowledge. The majority of the respondents insisted that the banks should upgrade there capacity so as to enhance the know-how of the employees.

Among the general remedies to be made concerning the staffs the following has been insisted by the respondents.

- In order to upgrade the staff knowledge there is a need to establish banking and finance institution, which is equipped with modern practices.
- The staffs need to have experience sharing with other countries financial sector.
- Encouraging the staffs to educate themselves to the next level.
- Train the staffs to use the modern technology.
- Continuous assessment of employee's salary.

d) Ownership structure (Government Vs private)

According to the survey result the respondents also demonstrated there possible forms of organization structure that speed up the reform to the opted level. Majority of he respondents has suggested the privatization of the current government owned banks would bring domestic banks to the level field to the foreign competitors.

CHAPTER FOUR

Conclusion and Recommendation

Conclusion

Out of prolonged request by the Ethiopia government to be a member in WTO, numerous questions has been raised and attempted at different times. However, during the current year following its step, the liberalization of financial and telecom has been requested by member countries. Basing our self on the financial sector the government for long insisted about infant industry argument. This paper by investigating the impact of foreign banks on domestic financial sector particularly focusing on banking industry suggests possible remedial action to be made by the government and possibly interested stakeholders in the banking sector. To my knowledge best, though there are papers on general benefit and risks of foreign banks this is the first paper that investigates the impact of foreign bank on domestic banking sector and gives the remedial action in a land of ours.

Literature in different transition countries identified that foreign banks operates with there two sword sides of benefits and risks. An initial condition towards foreign banks entry has been identified as an important step in order to avoid the risks and to tap the benefits of foreign banks.

Based on the analysis made in the previous section the following conclusions are forwarded on the comparison analysis of benefits and risks of foreign banks, the impact

of foreign banks on the efficiency reform of domestic sector, the impact of foreign banks on performance of domestic bank sector as well as the sequence of liberalization.

The survey respondents constitute of employees in the financial sector the majority of which constituted from banking sector. More than 80% of the total respondents are found to be working in the institution more than 5 years. This gives them enough experience to pinpoint the remedial action to be made in the sector. They were provided to rank each items of the above aspects.

First, the survey respondents were provided to rank the benefits and risks of foreign banks.

They agreed on each of the benefits and risks of foreign banks. Among the benefits provided they identified introducing new financial innovation as important one. From the risks the infant industry argument has been weighted as important by majority of the respondents. Though, agreement has been made on all benefits and risks, the benefits outweigh the risk.

Second, looking the topic from the policy prospect, the respondents were also provided with concerns identified by the policymakers. The survey respondents found to be in agreement with all the concerns sighted by policy makers. From the policy concern the majority of respondents insisted the capital outflow as an important among the others. The infant industry argument and limited supervisory capacity also identified to be the second and third risks, respectively cited by policy makers. This implies that there is a need to make important remedies on each of the concerns identified.

Though, the respondents ranked the risks identified by the policymakers more than the risks from literature they insisted the benefit of foreign banks outweigh the risks in both cases. Among the possible mode of entry the majority identified joint venture followed by foreign branches. This result, spotted by the respondents considering our country case is suggested to be proper. In case of joint venture though the foreigners doesn't involve more in holding share as well as management of branch it possible result in positive spillover and the adverse effect in terms of banks crises and performance will be less. In the second case it may be difficult to supervisory body to supervise and in case the parent bank faces crises moreover as sighted earlier domestic banks may fill the reduction in performance. In spite of these facts, however the parent can avail finance when the branch is unable to finance its clients.

Thirdly, respondents were ranked their views on the impact of foreign banks on efficiency and performance of foreign banks, if foreign banks allowed under the current conditions. With respect to efficiency reform the majority of respondent revealed their ideas that foreign banks bring all the efficiency reforms to financial sector in general and banking sectors in particular, except the reform that foreign bank bring in terms of lowering banking crises.

With relation to banking crises and financial liberalization literature identifies the increase in the capitalization of domestic banks as important one. However, the capitalization of domestic banks doesn't increase the welfare of the citizens. Among the survey respondent one identified that the merger of small private banks bring them to

have enough capital in order to do this, however, the government need to increase the supervisory body power.

The performance of domestic banks as a result of foreign banks entry identified to be with adverse effect. This becomes true in that foreign banks possibly attract domestic banks qualified staffs , reduces the market share , and reduces local bank total growth are identified to be the highest effect according to the orders listed. Following this the reduction in total growth, reduction in lending growth and reduction in credibility ranked to be the fourth , fifth and six impacts of foreign banks on performance of domestic bank ,respectively.

Of course that foreign bank will not operate in vacuum the suitability of the macroeconomic environment is the most important step for stability of the overall performance. The need for foreign exchange , to speed up the investment reform and to facilitate consumer credit are the most important macroeconomic and social indicators that calls the entry of foreign banks which is ranked by majority of respondents in there list.

Though, the above factors call foreign banks entry, the restructure of macroeconomic environment with respect to loosening the regulatory body directives and privatizing the telecom sectors suggested by many respondents.

Fourthly, from the risks assessed above the respondents were required to spot the remedial actions with respect to the reform for supervisory body, the ownership structure, the technology level and the human resource skill and knowledge required. As the

majority of the respondents agreed on each of the aspect cited. Among the remedies required they insisted the following among others.

- The staffs in the supervision must get enough experience taken from other countries, which have created well and stable environment with the foreign banks experience.
- Empower the regulatory capacity of the supervisory body.
- The staffs need to see exposure visits with other countries
- The ongoing study on national payment system should be streamlined for the application of modern and internationally accepted payment system.
- Latest technology should be adopted by the banks.
- Encouraging the staffs to educate themselves to the next level.
- Train the staffs to use the modern technology.
- Privatization of government owned banks

The above are among those remedies to be taken by the government and stakeholders of banks.

According to the survey the majority identified the liberalization of domestic financial sector followed by the stock market and capital account liberalization to be the order need to be followed to tap the benefits of foreign banks. Literature based on cross country evidence identified those who liberalized stock market first tap the benefits of efficiency from foreign banks entry.

Recommendation

If foreign banks allowed to operate, the survey respondents demonstrate an affirmative impact on domestic banking efficiency. However, foreign banks are expected to exert an adverse effect on performance and possibly exposing the sector to crises.

Therefore, the study recommends the following points so that the aforementioned risks can be removed for domestic banking or the argument to infant industry.

- The government should build the capacity of the supervising body.
- The supervisory authorities upgrade the quality and increase the size of their staffs in order to issue regulation in alliance with macroeconomic situation. In addition, supervisory bodies need to cooperate with foreign bank supervisory authorities. The supervisory staffs need to have exposure visit.
- The staffs in the supervisory body need to be updated technologically as well, so that they will issue laws related to e-banking, e-payment which the market is now lacking.
- The banks need to upgrade themselves technologically, if foreign banks allowed to operate the cost of this may be costly for the infant banks to update. In order to avoid possible costs and to manage the capital banks with lower capital need to merge. The supervisory body also needs to encourage this trend.

- Foreign banks expected to bring efficiency reform to domestic banking sector. The banks and employees need to adopt the change, not that only caused by foreign banks entry, but to learn how to be more competitive. In order to do this banks must encourage employees to continue there education to the next level and bring trainings and exposure of other courtiers experience.
- The local banks must work in order to serve the needs of the customers. So, they are expected to update there product timely.
- To keep the market stable and to protect the infant domestic banks the government needs to allow foreign banks in the form of joint venture.

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Annex I

Official Exchange Rate

1975/76-2007/08

1975/76	2.07
1976/77	2.07
1977/78	2.07
1978/79	2.07
1979/80	2.07
1980/81	2.07
1981/82	2.07
1982/83	2.07
1983/84	2.07
1984/85	2.07
1985/86	2.07
1986/87	2.07
1987/88	2.07
1988/89	2.07
1989/90	2.07
1990/91	2.07
1991/92	2.07
1992/93	5.0091
1993/94	5.7744
1994/95	6.2505
1995/96	6.3178
1996/97	6.5007
1997/98	6.8817
1998/99	7.5111

1999/00	8.1426
2000/01	8.3279
2001/02	8.5445
2002/03	8.5809
2003/04	8.6197
2004/05	8.6518
2005/06	8.681
2006/07	8.7943
2007/08	9.2441

Source: NBE Staff Computation

II- Interest Rate from 1975/76-2007/08

Year	Deposit interest rate	Lending interest rate
1970/71	0.06	0.09
1971/72	0.06	0.09
1972/73	0.06	0.09
1973/74	0.06	0.09
1974/75	0.06	0.09
1975/76	0.06	0.09
1976/77	0.06	0.09
1977/78	0.06	0.09
1978/79	0.06	0.09
1979/80	0.06	0.09
1980/81	0.06	0.09
1981/82	0.06	0.09
1982/83	0.06	0.09
1983/84	0.06	0.09
1984/85	0.06	0.09
1985/86	0.06	0.09
1986/87	0.06	0.07
1987/88	0.06	0.07
1988/89	0.06	0.07
1989/90	0.06	0.07
1990/91	0.06	0.07
1991/92	0.06	0.07
1992/93	0.11	0.15
1993/94	0.11	0.14
1994/95	0.10	0.15
1995/96	0.10	0.15
1996/97	0.11	0.16
1997/98	0.08	0.12
1998/99	0.06	0.12
1999/00	0.06	0.12
2000/01	0.07	0.13
2001/02	0.03	0.11
2002/03	0.03	0.11
2003/04	0.03	0.11
2004/05	0.03	0.11
2005/06	0.03	0.11
2006/07	0.03	0.11
2007/08	0.04	0.12

Source: NBE Staff Computation

III- Inflation during 1975/76-2007/08

Table 1. Annual Average Inflation

Year	Addis Ababa			National		
	General	Food	Non-food	General	Food	Non-food
1970						
1971	3.6	5.7	0.3			
1972	-5.2	-9.9	2.9			
1973	1.0	-0.7	3.3			
1974	10.7	13.8	6.0			
1975	4.7	2.0	8.9			
1976	18.9	24.5	10.9			
1977	21.9	29.4	9.7			
1978	18.6	18.9	18.0			
1979	13.0	14.4	7.7			
1980	12.5	14.9	8.8			
1981	1.9	2.1	0.9			
1982	7.3	4.8	13.4			
1983	3.9	6.8	-0.6			
1984	-0.3	-1.1	-1.5			
1985	16.4	23.4	4.4			
1986	6.5	8.4	4.8			
1987	-9.6	-15.9	5.7			
1988	2.3	-1.3	6.1			
1989	9.6	10.8	6.1			
1990	5.2	4.4	8.6			
1991	20.0	17.9	12.2			
1992	21.9	31.0	17.2			

1993	7.7	9.2	10.1			
1994	3.3	-0.02	4.7			
1995	13.4	16.8	2.6			
1996	0.9	2.3	5.0			
1997	-6.4	-8.1	-3.9			
1997/98*	1.0	-0.1	1.7	3.9	1.0	3
1998/99**	1.1	4.3	-3.5	4.3	9.9	-2.0
1999/00**	4.2	7.2	0.6	5.4	7.6	2.5
2000/01**	-1.4	-7.8	5.6	-0.3	-1.7	1.4
2001/02**	-5.5	-10.7	-0.8	-10.6	-19.1	0.3
2002/03**	4.6	9.4	0.9	10.9	21.5	0.2
2003/04**	5.6	8.6	3.0	7.3	11.5	2.2
2004/05**	7.2	5.7	7.6	6.1	7.4	4.4
2005/06**	8.4	13.0	4.6	10.6	13.0	7.1
2006/07**	19.2	25.4	14.0	15.8	17.5	13.5
2007/08	20.8	32.1	12.7	25.3	34.9	12.5

Source: NBE Staff computation

* 1995/96 base year of the national CPI

**2006 base year of the national CPI

1963-1997 of the A.A CPI 1963 as 100

Appendix IV

ADDIS ABABA UNIVERSITY
SCHOOL OF GRADUATE STUDIES
FACULTY OF BUSINESS AND ECONOMICS
DEPARTMENT OF ACCOUNTING AND FINANCE

Project Title: IS ETHIOPIA READY TO ACCEPT FOREIGN BANKS?

Dear Respondent

This questionnaire is designed to collect information related to allowing of foreign banks in Ethiopia. I want to look into the potential merits and accompanying risk associated to permitting of foreign banks to the domestic capital market. The research output will be useful to both academics and policy making bodies.

As this is research exercise to fulfill a requirement at AAU University, it will be used for same purpose. Your information will be kept confidential.

Thank you in advance for your cooperation!

A- General Information of Respondent

1. Please indicate the financial institution you work in.

- Bank
- Insurance companies
- Micro finance institution

2. Sex Male Female

3. How long have you been working in the financial institution?

- < 5 years 5 to 10 Years 11 to 20 years above 20 years

4. Your position in the organization.

- Manager Supervisor Clerk Other please specify _____

5. Your level of educational qualification.

- Master degree and above other please specify _____
 Bachelor Degree
 Diploma

B- Assessment of the research question

6. Is our banking industry capable of providing efficient service at reasonable cost?

- Yes. No.

7. Do our banks have the initiative and capacity to avail new products/services/ to their clients?

- Yes. No.

8. Will working with foreign banks help the domestic banks become more dynamic?

- Yes. No.

9. If foreign banks are allowed to operate, will they be willing to participate in the domestic market given the current macroeconomic conditions?

- Yes. No.

D) if your answer is yes, what kind of benefit will they bring to the market?

- (i) introduce new product/service
- (ii) efficiency reform
- (iii) enhance competitive environment
- (iv) other specify _____
- (v) _____

10. Different literature in transition countries reveals the benefits and risks of foreign banks.

a) How would you rate the potential benefit to the Ethiopia current situation, if foreign banks are allowed to operate?

Please make an (x) in the respective box.

	Responses				
	Strongly Agree	Agree	Neutral	Disagree	Strongly Disagree
Introduce new financial innovation					
Accelerate the economies of scale					
Develop the financial market					
Improve the financial system infrastructure					
Attracts foreign direct investment					
<u>Other please specifies.</u>					

b) How would you rate the potential costs to the Ethiopia current situation, if foreign banks are allowed to operate?

Please make an (x) in the respective box.

	Responses				
	Strongly Agree	Agree	Neutral	Disagree	Strongly Disagree
Foreign banks may reduce costs					
Domestic Banking as an infant industry becomes less competitive					
Retains credit to small firms					
Lack of domestic strong supervisory body					
<u>Other please specify:</u>					

11- According to the above suggestion mentioned in question No. 10, does the potential benefit outweigh the potential costs?

Yes.

NO.

12- The policymakers in Ethiopia have identified the following potential risks towards foreign bank entry. How would you rank the potential risks?

Please make an (x) in the respective box

	Responses				
	Strongly Agree	Agree	Neutral	Disagree	Strongly Disagree
Lack of interest by foreign banks to mobilize domestic capital.					
The infant industry argument					
Skews credit away from small and medium enterprise					
Limited supervisory capacity					
Fear of capital outflow					

13 - According to the potential benefit mentioned in question No.10 and the potential risks listed by the policymakers in question No. 12, does the potential benefit outweigh the potential costs?

Yes. No.

14. If your answer is **yes** to question No. 13. What will be the possible mode of entry among the following organizational form?

- (i) Representative office
- (ii) Foreign branch
- (iii) Bank subsidiary
- (iv) Joint Venture

Other _____

15. Literature in different transition countries reveals that foreign banks enhance the efficiency of domestic banks.

I) how would you rank the following potential efficiency reform to the general economy, if foreign banks are allowed to operate with current conditions?

Please make an (x) in the respective box.

	Responses				
	Strongly Agree	Agree	Neutral	Disagree	Strongly Disagree
Improve financial regulation					
Introduce other financial activities					
Attract a foreign direct investment					
Enhance the overall stability					

II.) How would you rank the following potential efficiency reform to the bank sector, if foreign banks allowed operating with current conditions?

Please make an (x) in the respective box.

	Responses				
	Strongly Agree	Agree	Neutral	Disagree	Strongly Disagree
Lower possible banking crises					
Provide a more stable source of credit					
Introduce new products and services					
Enhance the competitive environment					
Introduce a better supervision					
Introduce better disclosure					
Transfer of know how					
Transfer of good banking practice					
Encourage consolidation of banking service					

16. Which of the following macroeconomic and social indicators call foreign banks to enter the Ethiopia market?

Please give your response by placing an (x) mark in the respective box.

Macroeconomic and social indicators	Select	Rate 1- 4
<input type="radio"/> To reduce the population to bank ratio		
<input type="radio"/> The demand for foreign exchange		
<input type="radio"/> To speed up the investment reform		
<input type="radio"/> To lower bank lending rate		
<input type="radio"/> To facilitate consumer credit and mortgage		
<input type="radio"/> Other please specifies.		
<input type="radio"/> _____		
<input type="radio"/> _____		

17. Is the current macroeconomic environment likely to make the domestic banks competitive enough with their foreign competitors, if foreign banks are allowed to operate?

Yes.

No.

18. If your answer is No. to question no. 17. What are the remedial actions the government has to take to rectify this?

19. What will be the impact of foreign banks on the performance of Ethiopian domestic banks, if allowed to operate within the coming 5 years? **Please give your response by placing an (x) mark in the respective box.**

	Responses				
	Strongly Agree	Agree	Neutral	Disagree	Strongly Disagree
Foreign banks reduce local banks market share					
Foreign banks attracts qualified staffs					
Foreign banks reduce local bank credibility					
Foreign banks reduce local bank total growth					
Foreign banks reduce local bank total growth asset					
Foreign banks reduce local banks lending growth					

20. Which of the following bodies need to be reformed to bring domestic banks at par in the playing field, if foreign banks are allowed to operate in the market?

- I) Supervisory body yes. No.
II) Ownership structure (Government Vs Private) yes No.

If you answer is yes, please elaborate the remedial actions government has to take?

I) does the existing staff posses the required knowledge and skill to the desired level?

- Yes No.

If your answer is No .please elaborate the remedial actions government has to take?

II) Does the existing technological level bring domestic bank to a competitive position with their foreign competitors?

- Yes. No.

If your answer is No .please elaborate the remedies to be made.

21. Which of the following sequence need to be made to tap the foreign bank benefit? Rank in the order of their sequence to be opened. (Being 1- first to be opened, 3- the last)

- a) Liberalization of domestic financial sector
 b) Liberalization of capital account (offshore borrowing by institutions and multiple exchange rate market)
 c) Liberalization of stock market

>>>>>> **THANK YOU** >>>>>>

ANNEX V

BENEFITS OF FOREIGN BANKS

SUMMARY OF BENEFITS OF FOREIGN BANKS FROM THE LITERATURE

	N		Mean	Median	Mode	Std. Deviation	Minimum	Maximum
	Valid	Missing	100	Valid	Missing	100	Valid	Missing
Introduce new financial innovation	63	1	4.5238	5.0000	5.00	.75897	1.00	5.00
Accelerate the economies of scale	62	2	3.8226	4.0000	4.00	.84007	2.00	5.00
Develop the financial market	62	2	4.1935	4.0000	4.00	.67359	2.00	5.00
Improve the financial system infrastructure	63	1	4.1587	4.0000	4.00	.84637	2.00	5.00
Attract foreign direct investment	63	1	4.2698	4.0000	5.00	.76636	2.00	5.00

Introduce new financial innovation

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	strongly disagree	1	1.6	1.6	1.6
	diagree	1	1.6	1.6	3.2
	neutral	1	1.6	1.6	4.8
	agree	21	32.8	33.3	38.1
	strongly agree	39	60.9	61.9	100.0
	Total	63	98.4	100.0	
Missing	System	1	1.6		
Total		64	100.0		

Accelerate the economies of scale

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	disagree	3	4.7	4.8	4.8
	neutral	19	29.7	30.6	35.5
	agree	26	40.6	41.9	77.4
	strongly agree	14	21.9	22.6	100.0
	Total	62	96.9	100.0	
Missing	System	2	3.1		
Total		64	100.0		

Developed the financial market

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	disagree	1	1.6	1.6	1.6
	neutral	6	9.4	9.7	11.3
	agree	35	54.7	56.5	67.7
	strongly agree	20	31.3	32.3	100.0
	Total	62	96.9	100.0	
Missing	System	2	3.1		
Total		64	100.0		

Improve the financial system infrastructure

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	disagree	3	4.7	4.8	4.8
	neutral	9	14.1	14.3	19.0
	agree	26	40.6	41.3	60.3
	strongly agree	25	39.1	39.7	100.0
	Total	63	98.4	100.0	
Missing	System	1	1.6		
Total		64	100.0		

Attract foreign direct investment

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	disagree	1	1.6	1.6	1.6
	neutral	9	14.1	14.3	15.9
	agree	25	39.1	39.7	55.6
	strongly agree	28	43.8	44.4	100.0
	Total	63	98.4	100.0	
Missing	System	1	1.6		
Total		64	100.0		

RISKS OF FOREIGN BANKS

SUMMARY OF RISKS OF FOREIGN BANKS

	N		Mean	Median	Mode	Std. Deviation	Minimum	Maximum
	Valid	Missing	100	Valid	Missing	100	Valid	Missing
Foreign banks may reduce costs	61	3	3.4426	4.0000	4.00	1.04123	1.00	5.00
Domestic banking as an infant industry becomes less competitive	64	0	4.1875	5.0000	5.00	1.05221	1.00	5.00
Retain credit to small firms	59	5	3.2881	3.0000	3.00	.94779	1.00	5.00
Lack of domestic strong supervisory body	64	0	3.9844	4.0000	5.00	1.09098	2.00	5.00

Foreign banks may reduce costs

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	strongly disagree	1	1.6	1.6	1.6
	disagree	13	20.3	21.3	23.0
	neutral	14	21.9	23.0	45.9
	agree	24	37.5	39.3	85.2
	strongly agree	9	14.1	14.8	100.0
	Total	61	95.3	100.0	
Missing	System	3	4.7		
Total		64	100.0		

Domestic banking as an infant industry becomes less competitive

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	strongly disagree	1	1.6	1.6	1.6
	disagree	6	9.4	9.4	10.9
	neutral	6	9.4	9.4	20.3
	agree	18	28.1	28.1	48.4
	strongly agree	33	51.6	51.6	100.0
	Total	64	100.0	100.0	

Retain credit to small firms

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	strongly disagree	1	1.6	1.7	1.7
	disagree	11	17.2	18.6	20.3
	neutral	23	35.9	39.0	59.3
	agree	18	28.1	30.5	89.8
	strongly agree	6	9.4	10.2	100.0
	Total	59	92.2	100.0	
Missing	System	5	7.8		
Total		64	100.0		

Lack of domestic strong supervisory body

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	disagree	9	14.1	14.1	14.1
	neutral	11	17.2	17.2	31.3
	agree	16	25.0	25.0	56.3
	strongly agree	28	43.8	43.8	100.0
	Total	64	100.0	100.0	

RISKS OF FOREIGN BANKS CITED BY POLICY MAKERS FROM SURVEY RESPONDENTS

Risks of foreign banks	N		Mean	Median	Mode	Std. Deviation	Minimum	Maximum
	Valid	Missing	100	Valid	Missing	100	Valid	Missing
Lack of interest by foreign banks to mobilize domestic capital	63	1	3.4603	3.0000	3.00	1.10461	1.00	5.00
The infant industry agreement	63	1	4.0476	4.0000	4.00	.97432	1.00	5.00
Skew credit away from SME	61	3	3.6230	4.0000	4.00	.89748	2.00	5.00
limited supervisory position	63	1	3.9841	4.0000	5.00	1.02378	2.00	5.00
Fear of capital outflow	62	2	4.3226	5.0000	5.00	.90126	1.00	5.00

Lack of interest by foreign banks to mobilize domestic capital

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	strongly disagree	2	3.1	3.2	3.2
	disagree	10	15.6	15.9	19.0
	neutral	22	34.4	34.9	54.0
	agree	15	23.4	23.8	77.8
	strongly agree	14	21.9	22.2	100.0
	Total	63	98.4	100.0	
Missing	System	1	1.6		
Total		64	100.0		

The infant industry agreement

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	strongly disagree	1	1.6	1.6	1.6
	disagree	5	7.8	7.9	9.5
	neutral	7	10.9	11.1	20.6
	agree	27	42.2	42.9	63.5
	strongly agree	23	35.9	36.5	100.0
Total		63	98.4	100.0	
Missing	System	1	1.6		
Total		64	100.0		

Skew credit away from SME

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	disagree	8	12.5	13.1	13.1
	neutral	16	25.0	26.2	39.3
	agree	28	43.8	45.9	85.2
	strongly agree	9	14.1	14.8	100.0
	Total		61	95.3	100.0
Missing	System	3	4.7		
Total		64	100.0		

Limited supervisory position

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	disagree	8	12.5	12.7	12.7
	neutral	9	14.1	14.3	27.0
	agree	22	34.4	34.9	61.9
	strongly agree	24	37.5	38.1	100.0
	Total		63	98.4	100.0
Missing	System	1	1.6		
Total		64	100.0		

Fear of capital outflow

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	strongly disagree	1	1.6	1.6	1.6
	disagree	2	3.1	3.2	4.8
	neutral	6	9.4	9.7	14.5
	agree	20	31.3	32.3	46.8
	strongly agree	33	51.6	53.2	100.0
	Total	62	96.9	100.0	
Missing	System	2	3.1		
Total		64	100.0		

Statistics

	N		Mean	Median	Mode	Std. Deviation	Minimum	Maximum	Percentiles
	Valid	Missing	100	Valid	Missing	100	Valid	Missing	100
Comparison between benefit and risks of foreign banks	62	2	1.3226	1.0000	1.00	.47128	1.00	2.00	2.0000
Benefit of foreign bank outweigh the risk of policymakers	60	4	1.4333	1.0000	1.00	.49972	1.00	2.00	2.0000

Comparison between benefit and risks of foreign banks

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	yes	42	65.6	67.7	67.7
	no	20	31.3	32.3	100.0
	Total	62	96.9	100.0	
Missing	System	2	3.1		
Total		64	100.0		

Benefit of foreign bank outweigh the risk of policymakers

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	yes	34	53.1	56.7	56.7
	no	26	40.6	43.3	100.0
	Total	60	93.8	100.0	
Missing	System	4	6.3		
Total		64	100.0		

Mode of entry

N	Valid	29
	Missing	35
Mean		2.5517
Median		2.0000
Mode		4.00
Std. Deviation		1.24172
Minimum		1.00
Maximum		4.00
Percentiles	100	4.0000

Entry mode

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Representative office	7	10.9	24.1	24.1
	Foreign branch	10	15.6	34.5	58.6
	Bank subsidiary	1	1.6	3.4	62.1
	Joint venture	11	17.2	37.9	100.0
	Total	29	45.3	100.0	
Missing	System	35	54.7		
Total		64	100.0		

EFFICIENCY REFORM TO THE GENERAL ECONOMY

	N		Mean	Median	Mode	Std. Deviation	Minimum	Maximum	Percentiles
	Valid	Missing	100	Valid	Missing	100	Valid	Missing	100
Improve financial regulation	63	1	3.7619	4.0000	4.00	1.02728	1.00	5.00	5.0000
Introduce other financial activities	64	0	4.4531	4.0000	4.00(a)	.56145	3.00	5.00	5.0000
Attract foreign direct investment	64	0	4.3125	4.0000	4.00	.66368	3.00	5.00	5.0000
Enhance the overall stability	62	2	3.0484	3.0000	3.00	.85751	1.00	5.00	5.0000

Improve financial regulation

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	strongly disagree	1	1.6	1.6	1.6
	disagree	8	12.5	12.7	14.3
	neutral	12	18.8	19.0	33.3
	agree	26	40.6	41.3	74.6
	strongly agree	16	25.0	25.4	100.0
Total		63	98.4	100.0	
Missing	System	1	1.6		
Total		64	100.0		

Introduce other financial activities

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	neutral	2	3.1	3.1	3.1
	agree	31	48.4	48.4	51.6
	strongly agree	31	48.4	48.4	100.0
	Total	64	100.0	100.0	

Attract foreign direct investment

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	neutral	7	10.9	10.9	10.9
	agree	30	46.9	46.9	57.8
	strongly agree	27	42.2	42.2	100.0
	Total	64	100.0	100.0	

Enhance the overall stability

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	strongly disagree	3	4.7	4.8	4.8
	disagree	9	14.1	14.5	19.4
	neutral	35	54.7	56.5	75.8
	agree	12	18.8	19.4	95.2
	strongly agree	3	4.7	4.8	100.0
Total		62	96.9	100.0	
Missing	System	2	3.1		
Total		64	100.0		

EFFICIENCY REFOR TO THE BANKING INDUSTRY

	N		Mean	Median	Mode	Std. Deviation	Minimum	Maximum	Percentiles
	Valid	Missing	100	Valid	Missing	100	Valid	Missing	100
Lower possible banking crises	63	1	2.7619	3.0000	3.00	.91077	1.00	5.00	5.0000
Provide a more stable source of credit	63	1	3.4603	4.0000	4.00	.99718	1.00	5.00	5.0000
Introduce new product and service	63	1	4.4921	4.0000	4.00	.50395	4.00	5.00	5.0000
Enhance the competitive environment	63	1	4.1111	4.0000	4.00	.93517	1.00	5.00	5.0000
Introduce a better supervision	64	0	3.6406	4.0000	4.00	.94897	1.00	5.00	5.0000
Introduce a better disclosure	63	1	3.7143	4.0000	4.00	.72798	2.00	5.00	5.0000
Transfer of know how	62	2	4.5323	5.0000	5.00	.56446	3.00	5.00	5.0000
Transfer of good banking practice	63	1	4.4127	5.0000	5.00	.71018	2.00	5.00	5.0000
Encourage consolidation of banking service	62	2	4.0323	4.0000	4.00	.74587	1.00	5.00	5.0000

Lower possible banking crises

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	strongly disagree	4	6.3	6.3	6.3
	disagree	21	32.8	33.3	39.7
	neutral	26	40.6	41.3	81.0
	agree	10	15.6	15.9	96.8
	strongly agree	2	3.1	3.2	100.0
	Total	63	98.4	100.0	
Missing	System	1	1.6		
Total		64	100.0		

Provide a more stable source of credit

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	strongly disagree	2	3.1	3.2	3.2
	disagree	9	14.1	14.3	17.5
	neutral	18	28.1	28.6	46.0
	agree	26	40.6	41.3	87.3
	strogly agree	8	12.5	12.7	100.0
	Total	63	98.4	100.0	
Missing	System	1	1.6		
Total		64	100.0		

Introduce new product and service

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	agree	32	50.0	50.8	50.8
	strongly agree	31	48.4	49.2	100.0
	Total	63	98.4	100.0	
Missing	System	1	1.6		
Total		64	100.0		

Enhance the competitive environment

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	strongly disagree	2	3.1	3.2	3.2
	disagree	2	3.1	3.2	6.3
	neutral	6	9.4	9.5	15.9
	agree	30	46.9	47.6	63.5
	strongly agree	23	35.9	36.5	100.0
	Total	63	98.4	100.0	
Missing	System	1	1.6		
Total		64	100.0		

Introduce a better supervision

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	strongly disagree	1	1.6	1.6	1.6
	disagree	7	10.9	10.9	12.5
	neutral	17	26.6	26.6	39.1
	agree	28	43.8	43.8	82.8
	strongly agree	11	17.2	17.2	100.0
Total		64	100.0	100.0	

Introduce a better disclosure

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	disagree	4	6.3	6.3	6.3
	neutral	16	25.0	25.4	31.7
	agree	37	57.8	58.7	90.5
	strongly agree	6	9.4	9.5	100.0
	Total	63	98.4	100.0	
Missing	System	1	1.6		
Total		64	100.0		

Transfer of know how

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	neutral	2	3.1	3.2	3.2
	agree	25	39.1	40.3	43.5
	strongly agree	35	54.7	56.5	100.0
	Total	62	96.9	100.0	
Missing	System	2	3.1		
Total		64	100.0		

Transfer of good banking practice

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	disagree	1	1.6	1.6	1.6
	neutral	5	7.8	7.9	9.5
	agree	24	37.5	38.1	47.6
	strongly agree	33	51.6	52.4	100.0
	Total	63	98.4	100.0	
Missing	System	1	1.6		
Total		64	100.0		

Encourage consolidation of banking service

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	strongly disagree	1	1.6	1.6	1.6
	disagree	1	1.6	1.6	3.2
	neutral	7	10.9	11.3	14.5
	agree	39	60.9	62.9	77.4
	strongly agree	14	21.9	22.6	100.0
Total		62	96.9	100.0	
Missing	System	2	3.1		
Total		64	100.0		

POTENTIAL EFFECT OF FOREIGN BANK ENTRY ON PERFORMANCE OF DOMESTIC BANKS

	N		Mean	Median	Mode	Std. Deviation	Minimum	Maximum	Percentiles
	Valid	Missing	100	Valid	Missing	100	Valid	Missing	100
Foreign banks reduce local banks market share	64	0	4.3281	5.0000	5.00	.89184	2.00	5.00	5.0000
Foreign banks attract qualified staffs	64	0	4.6563	5.0000	5.00	.54098	3.00	5.00	5.0000
Foreign banks reduce local bank credibility	62	2	3.1613	3.0000	3.00	1.17618	1.00	5.00	5.0000
Foreign banks reduce local bank total growth	64	0	3.5000	4.0000	4.00	1.06904	1.00	5.00	5.0000
Foreign banks reduce local bank total growth asset	62	2	3.5323	4.0000	4.00	1.05143	1.00	5.00	5.0000
Foreign banks reduce local banks lending growth	62	2	3.4839	4.0000	4.00	1.11240	1.00	5.00	5.0000

Foreign banks reduce local banks market share

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	disagree	4	6.3	6.3	6.3
	neutral	6	9.4	9.4	15.6
	agree	19	29.7	29.7	45.3
	strongly agree	35	54.7	54.7	100.0
Total		64	100.0	100.0	

Foreign banks attract qualified staffs

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	neutral	2	3.1	3.1	3.1
	agree	18	28.1	28.1	31.3
	strongly agree	44	68.8	68.8	100.0
	Total	64	100.0	100.0	

Foreign banks reduce local bank credibility

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	strongly disagree	5	7.8	8.1	8.1
	disagree	13	20.3	21.0	29.0
	neutral	21	32.8	33.9	62.9
	agree	13	20.3	21.0	83.9
	strongly agree	10	15.6	16.1	100.0
	Total	62	96.9	100.0	
Missing	System	2	3.1		
Total		64	100.0		

Foreign banks reduce local bank total growth

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	strongly disagree	1	1.6	1.6	1.6
	disagree	14	21.9	21.9	23.4
	neutral	12	18.8	18.8	42.2
	agree	26	40.6	40.6	82.8
	strongly agree	11	17.2	17.2	100.0
	Total	64	100.0	100.0	

Foreign banks reduce local bank total growth asset

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Strongly disagree	1	1.6	1.6	1.6
	disagree	13	20.3	21.0	22.6
	neutral	10	15.6	16.1	38.7
	agree	28	43.8	45.2	83.9
	strongly agree	10	15.6	16.1	100.0
	Total	62	96.9	100.0	
Missing	System	2	3.1		
Total		64	100.0		

Foreign banks reduce local banks lending growth

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	strongly disagree	3	4.7	4.8	4.8
	disagree	12	18.8	19.4	24.2
	neutral	8	12.5	12.9	37.1
	agree	30	46.9	48.4	85.5
	strongly agree	9	14.1	14.5	100.0
	Total	62	96.9	100.0	
Missing	System	2	3.1		
Total		64	100.0		