SAINT MARY UNIVERSITY

SCHOOL OF GRADUATE STUDIES

GENERAL MBA PROGRAM

RESERVATION OF ETHIOPIA'S BANKING SECTOR TO LOCAL ACTORS: ASSESSING ITS IMPLICATIONS ON THE FOREIGN CURRENCY FLOW OF THE COUNTRY

BY

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JULY, 2018

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A THESIS SUBMITTED TO ST. MARY UNIVERSITY SCHOOL OF GRADUATE STUDIES IN PARTIAL FULFILLMENT OF THE REQUIREMENT FOR THE AWARD OF THE DEGREE OF MASTERS OF BUSINESS ADMINSTRATION IN GENERAL MANAGEMENT

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Declaration

I, Henock Demissie declare that ‘‘Reservation of Ethiopia’s Banking Sector to Local Actors: Assessing its Implications on the Foreign Currency Flow of the Country’’ is my own work that has not been submitted for any degree or any other examination in any other university.

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LIST OF ABBREVIATIONS AND ACRONYMS

CBE: Commercial Bank of Ethiopia

EEA: Ethiopian Economists Association

EUR: Euro

FDI: Foreign Direct Investment

FOREX: Foreign Exchange

GBP: Great Britain Pound

GDP: Gross Domestic Product

IMF: International Monetary Funds

M & A: Merger and Acquisition

MOFEC: Ministry of Finance and Economic Cooperation

NBE: National Bank of Ethiopia

NPC: National Planning Commission

USD: United States Dollar

WTO: World Trade Organization

Abstract

This study is conducted to analyze the implications of Ethiopia's policy of reserving its banking sector to local actors on the foreign currency flow of the country. An exploratory study was employed so as to achieve the research objectives. The target population includes foreign bank representative offices, branch managers and economists from National Bank of Ethiopia, Ethiopian Economics Association, National Planning Commission, Ministry of Finance and Economic Cooperation and the World Bank. To select sample from the population, purposive sampling technique was used. In order to get relevant data from the target population qualitative approach was used. As a result, semi structured interview was used to gather data from the sample subjects. Nine individuals from six institutions were interviewed. The data collected from the respondents was then put into different categories based on similarity and analysis was made. The findings of the study generally indicated that liberalizing Ethiopia's banking sector would facilitate trade, allow more FDI to flow into the country, enhance the efficiency and competitiveness of Ethiopia's exports. The study shows how liberalization could lead to outflows of foreign currency and damage the economy. The study also shows that the importance of the country's government regulatory and supervision capacity and the country's overall political climate. Finally, the study forwarded some possible recommendations in order to improve the country's foreign currency shortage by building a strong export sector and regulatory capacity as well as strengthening the local banks by placing policies that are friendly to the sector.

Key Words: Banking Sector, Foreign Currency, Foreign Banks, Liberalization

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CHAPTER ONE

Introduction

1.1 Background of the Study

Ethiopia's financial sector also seems to be flourishing only recently. Despite the improvement in the last couples of years, Ethiopian banking remains in its low status. For banking, the state - owned banks seem to dominate the industry. Surprisingly, the Commercial Bank of Ethiopia (CBE) - the largest bank in Ethiopia CBE) alone controls for nearly half of the branch networks, capital, outstanding loans and advances, and more than half of the deposit of the country's banks. In general, the sector is characterized by small banking, limited range of services, absence of capital markets and the sector largely remains closed to foreign investors.

Currently Ethiopia has 18 banks, 16 were private and 2 state-owned. Accordingly, the number of banks stood at 18. The share of private banks in total branch network rose to 66.6 percent from 61.8 percent last year, in line with the branch expansion target set for private banks in GTP II. Following a significant capital injection by Commercial Bank of Ethiopia, the total capital of the banking industry increased by 81.1 percent and reached Birr 78.0 billion by the end of June 2017(NBE, 2017).

Currency is any generally accepted medium of exchange for goods and services in a particular country or region which normally takes the form of paper notes and coins (Kocic, 2010). According to Ernst & Young (2017) foreign currency is a currency other than the functional currency of the entity being referred to. For example, for a Japanese entity that determines the Japanese Yen is its functional currency, any currency other than Japanese Yen would be considered a foreign currency. Ethiopia's central bank i.e. the National Bank of Ethiopia (NBE) define foreign currency as a means any currency other than Ethiopian legal tender in any country outside Ethiopia as to which the NBE has declared to be acceptable for payment in Ethiopia (National Bank of Ethiopia, 2017).

For any country foreign currency is pertinent. A country trades with its partners by using foreign currency as a means of exchange. Manchev et al (2009) each country faces constant demands for foreign payments on demand for trade purposes, necessitating a reserve to accumulate and disburse foreign payments. Countries generally maintain reserves in order to effectively manage their exchange rate and to reduce adjustment costs associated with fluctuations in international payments **(**Elhiraika and Ndikumana, 2007).

Furthermore, in today's globalized world foreign currency reserves can determine the well being of the whole economy. Adequate foreign exchange reserves are an important factor of any well-managed economy and the reserves help cushion the effects of economic shocks, domestic or international (Keatinge, 2014). According to European Central Bank (2017) the U.S. dollar (USD) accounts for 64% of the global currency reserve followed by the Euro (EUR) which is 19.7%.

As a country increases its exports it will hold more reserves. One way of boosting exports is the ability to produce sophisticated products that can compete in the global arena. Mostly developed countries have the capacity to produce such products and services.

Rich and skilled nations will produce advanced and high-value goods (or the final stages of a process in a global value chain), while the poor nations will produce raw materials (primary production in general) and low-value goods. Hence, developing nations like Ethiopia rely on imports to acquire sophisticated products and services (Felipe et.al, 2010).

According to World Bank (2017) Ethiopia's export sector is particularly small. The total export of goods and services exports does not exceed 10 percent of GDP, significantly below the 24 percent expected from countries at this level of development''. Its exports-to-GDP ratio in 2015 was the fifth lowest in the world—highly concentrated in primary products (IMF, 2018) Thus, there is imbalance between imports and exports. Imports exceed exports by a wide margin; putting the country in a trade deficit. Sennoga et.al, (2017) Merchandise export revenues were USD 2.9 billion in 2015/16 while the value of merchandise imports increased to USD 16.7 billion. Consequently, Ethiopia has low foreign currency reserves.

In order to fill the gap related to foreign currency countries allow foreign banks to operate in their economy. As the banks operate internationally, they tend to have more foreign currency reserves compared to the local banks. Thus; they can provide liquidity in the form of foreign currency. In Ethiopia's context foreign banks are not allowed to enter the banking sector of the country. Therefore, Ethiopia's foreign currency shortage will not be reduced or improved by the participation of foreign banks.

National Bank of Ethiopia (NBE) proclamation no. 592/2008 prohibits foreign banks from operating in the country. In the proclamation part two; Licensing Banking Business, section six; it states that; Foreign nationals or organizations fully or partially owned by foreign nationals may not be allowed to open banks or branch offices or subsidiaries of foreign banks in Ethiopia or acquire the shares of Ethiopian banks.. Though the government of Ethiopia is trying to address the problem by taking different measures, yet foreign currency remains a challenge.

Currently, banks primarily provide foreign currency for sectors that are given priority by the government. Directive no, FXD/46/2017 of the National Bank of Ethiopia states that; in the allocation of foreign currency a bank shall give priority to import items and payments such as fuel, motor oil, lubricants and LGP gas , fertilizer, agricultural inputs and machineries and pharmaceutical products on the first come first served basis (National Bank of Ethiopia, 2017).

Therefore due attention should be given to foreign currency as it has a great importance to Ethiopia's economy. This study will try to understand the implications as a result of the policy that prohibits foreign banks to operate in Ethiopia's banking sector associated with the foreign currency flow of the country.

1.2 Statement of the Problem

Most of the time developing countries like Ethiopia have low foreign exchange reserves since they experience a large trade deficit. According to Lelissa (2015) huge demand for strategic goods such as petroleum, extended public investment, imported inflation, erratic foreign aid inflow, accumulated and uprising demand of non-strategic imports and poor foreign currency earning capacity are some of the reasons for the current liquidity constraint in Ethiopia.

According to Yewondwossen (2018) Ethiopia's forex shortage has seriously affected private sector activity. This has not only negatively affected import businesses in all areas, but is especially true in the manufacturing sector with small scale businesses and heavy industries.

Hence, to transform the economy into industrialization and ensure sustainable economic development; foreign currency reserves are vital. Foreign currency is a challenge both for the government and private sector. According to a report by the IMF in 2018, Gross official reserves of the country are estimated to be 3,197 million USD; which can only cover imports for 1.9 months. Using traditional metrics, based on simple rules of thumb; three months' coverage of imports is used as a benchmark (IMF, 2011).

Although there are a number of justifications for this, one acclaimed justification is the prohibition of foreign banks by the government from legally operating in the country. This claim is based on the fact that foreign banks have more foreign exchange reserves than their Ethiopian counterparts. In this regard, various studies such as Kiyota et al (2007) and Amanuel (2009) have been made about how Ethiopia can benefit by allowing foreign banks to operate in its economy. Nevertheless, to the best knowledge of the researcher, the implication it has on the foreign currency flow of the country has not been studied extensively. Furthermore, previously conducted studies related to liberalization are mostly quantitative. Thus, it is important to analyze how prohibiting foreign banks affects the country's foreign currency flow.

Therefore the study aims to fill the gap by providing qualitative analysis about the policy's implications on the foreign currency flow in Ethiopia.

1.3 Research Questions

The research intends to answer these questions;

1. Do foreign banks contribute positively towards the country's foreign currency shortage i.e. improve the forex circulation; if Ethiopia's government liberalizes the banking sector?
2. Do foreign banks be willing to invest given the country's current economy?
3. Do foreign banks be willing to invest given the current political situation in the country?
4. Do foreign banks inject substantial amount of foreign currency taking into account the current regulatory framework of NBE?
5. Can foreign banks invest heavily considering the country's potential?

1.4 Objective of the Study

1.4.1 General Objective

In general this study intends to analyze the policy of reserving Ethiopia's banking sector to local actors and its implications on the foreign currency flow of the country.

1.4.2 Specific Objectives

1. To find out the contribution of foreign banks in the current foreign exchange shortage of the country if Ethiopia's banking sector is liberalized.

2. To make a contextual analysis on the willingness of foreign banks to inject foreign currency into the economy taking into account the current political and economic performance of the country.

3. To figure out the policy of reserving the banking sector to local actors implications on the foreign exchange reserves of Ethiopia.

1.5 Scope and limitation of the study

1.5.1 Scope

Ethiopia's government policy of prohibiting foreign banks from operating in the country has several implications. However, this study focused only on the implications of the policy on the foreign currency flow of the country.

1.5.2 Limitation

Previously, this research area; especially in the Ethiopian context, has not been adequately explored to a level that can briefly demonstrate the relation between liberalization of a country's banking sector and foreign currency flow; which may undermine the quality and relevance of secondary data in the area. Due to this fact, the researcher has relied on his own inferences and intellectual analysis rather than basing himself on previous references.

More data could be gathered and analysis could be made based on it, if mixed approach i.e. both qualitative and quantitative is adopted. In addition to the semi structured interview; distributing questionnaires would help collect more data as it is very difficult to find and interview a large number of economists or other experts related to the study topic. Because of the difficulty in finding and distribute questionnaires to a large number of economists, the researcher has only used qualitative approach.

1.6 Significance of the study

The outcome of this research is relevant to:

1. Policy makers – the study can be used as an input for policy makers such as NBE and the government at large; as it provides an insight about the implications of the policy of the government.
2. Investors – the study will provide information about key indicators of Ethiopia's economy such as export performance of the country, the policies regarding foreign currency and its foreign currency reserve which are important for any investor that wants to invest in the country in different sectors.
3. The findings and recommendations of the study can be used as a reference by anyone who wants to further investigate the policy's impact or other related topics.

1.7 Organization of the study

Following chapter one, in chapter two; the relevant literature will be discussed. Chapter three is the research methodology part. Here the research design, the sampling techniques, data sources and gathering methods and finally data analysis method are discussed. In chapter four findings of the study are presented. Chapter five will be the last chapter of the paper. Based on the findings, conclusions and recommendations are made and future research direction is also suggested.

CHAPTER TWO

Review of Related Literature

2.1 Foreign Currency and Foreign Currency Reserves

2.1.1 Definition of Foreign Currency

Foreign currency is the currency of any foreign country which is authorized medium of circulation and basis for record keeping in that country. It is traded by banks either by the actual handling of currency or checks or by establishing balances in foreign currency with banks in those countries (Dictionary of International Trade, 2018). Ethiopia's financial sector is relatively underdeveloped, with about two-thirds of total bank credit channeled to government enterprises (IMF, 2017).

2.1.2 Foreign Exchange Reserves

According to Sharma (2016) foreign-exchange reserves (also called forex reserves or FX reserves) is money or other assets held by a central bank or other monetary authority so that it can pay if need be its liabilities, such as the currency issued by the central bank, as well as the various bank reserves deposited with the central bank by the government and other financial institutions.

Foreign exchange reserves should ideally include foreign bank notes, foreign bank deposits, foreign treasury bills, and short and long-term foreign government securities. However, they also include gold reserves, special drawing rights (SDRs), and International Monetary Fund (IMF) reserve positions. Foreign-exchange reserves are called reserve assets in the balance of payments and are located in the capital account. Hence, form an important part of the international investment position of a country (Sharma, 2016).

A country with a hard currency, such as the US dollar, sterling or the euro, has little need to be concerned about the level of foreign exchange reserves. Their currencies are acceptable across the globe. However, very often, non-US dollar currencies are acceptable largely because the countries involved have substantial foreign exchange reserves (Williams, 2005).

Though currencies of some of the world’s top economies such as the U.S. dollar, Euro and the Japanese Yen are held as a reserve currency, for a country being among the world’s biggest economies in terms of GDP doesn’t necessarily mean its currency will be a reserve currency hold by other countries in significant amount.

Reserve currency status does not necessarily reflect a country’s relative economic weight but is attributed to several economic, financial and political factors including network externalities, third countries’ FX policies (e.g. currency pegs and baskets) and depth of its financial market. Despite China’s economic rise over the last decades, the importance of the renminbi as global reserve currency still remains low. The People’s Republic of China is now the world’s third largest economy (the largest in terms of PPP-adjusted GDP) after the US and the European Union, but the renminbi only accounts for a fraction of currency reserves. (Koerner and Winkler, 2017)

Koerner and Winkler also argued that reserve currency status doesn’t always justify a country’s economic hegemony. “There also seems to be some element of inertia in reserve allocation, often illustrated by the dominance of the British pound in the first half of the 20th century, when the US had already long taken over as the strongest economic power”.

2.1.3 The Importance of Holding Foreign Reserves

Several scholars have stressed about the importance of holding foreign reserves. qqAccording to Manchev et al. (2009) foreign reserves have the following main purposes:

• To act as a monetary policy instrument;

• To act as an exchange rate instrument helping cut fluctuations in the exchange rates of the national currency against foreign currencies, or maintain a set exchange rate;

• To act as a liquidity buffer in case of an international financial market crash;

• To reduce vulnerability to external factors and safeguard against crises;

• To boost stability and confidence in financial markets, since re- serves are among the foremost indicators monitored by international ratings agencies;

• To act as a source of subsidiary revenue derived from managing them.

Foreign currency reserves can be important determinant for economic growth. Taking Brazil's economy from 1980-2014 as a sample Kashif et al, (2017) argued that economic growth has positive impact on international reserves in Brazil. The results reveal that, ceteris paribus, 1 per cent increase in economic growth will lead 0.16 per cent upsurge in international reserves holdings of Brazil. These results can be generalized to argue that large stockpiles of international reserves may be due to foreign trade and economic growth. This is one of the reasons why Brazil hoards large stockpiles of foreign reserves. Therefore, it seems reasonable to accumulate a sufficient amount of international reserves by Banco Central do Brasil.

The ability of a country's economy to generate foreign exchange is very important to assure the sustainability of a country's reserves in the long run. While the level of foreign exchange reserves is influenced by the way in which reserves are managed, it is the underlying strength of the economy, and the ability to earn foreign exchange which are vital. In the Caribbean many countries consistently post current account deficits and rely on capital inflows to offset these deficits. However, where current account deficits become very large, dependence on capital inflows can be precarious as experienced in the nineties by Latin America.

Perversely, because Caribbean capital markets are not yet very deep, capital flows tend to be less volatile, so for the time being, there is no evidence of excessive volatility in the capital markets of most of the English-speaking Caribbean, though there is greater volatility in Jamaica than in the rest of the Caribbean. The prognosis therefore, would tend to indicate that as the Caribbean deepens its capital market – which it is making every effort to do –Central Banks in the region may need to hold higher levels of foreign exchange reserves in order to deal with the volatility which can result unless they are willing to let the exchange rate depreciate (Williams, 2005).

Holding foreign reserves by its self cannot be regarded as positive for a country's economy. The self-insurance argument is the most important explanation for the build-up. After the painful experience during the Asian crisis and with on-going financial integration, emerging Asian countries want to rely only on themselves, in terms of staying liquid during a crisis. So they accept the cost associated with holding reserves in order to prevent incurring the costs of a crisis.

But the costs of holding reserves are high not only for the country holding them, but also for the world, causing global imbalances which can result in a crisis such as the current one.

The global financial crisis, which also spread to emerging Asia, showed that emerging Asian countries did not use their stockpile of foreign reserves; instead the accumulation went on. These countries survived the crisis better and recovered faster. But the question remains whether this was due to the foreign reserves and in particular, whether it was due to these high levels of foreign reserves. Would a lower level of reserves not have had the same deterrent effect? Hence, foreign reserves can be both a curse and a blessing, as they can both cause and smooth a crisis. As long as no adequate level of foreign reserves can be determined, the discussion will go on (Pechotski, 2012).

2.2 Liberalization of Banking Sector and its Impact on a Country's Economy

Entry of foreign banks may not always improve the banking sector of developing countries. Tressel et al. (2006) the cream-skimming model predicts that countries with more foreign bank penetration should have a shallower banking sector, and that foreign banks should have a safer loan portfolio than domestic banks within each country. We find these predictions to be consistent with data from a sample of 60 lower income countries. These findings are clearly at odds with hopes that foreign banks might replace inefficient and corrupt state and domestic banks and boost financial development in poor countries.

2.3 Liberalization of the Banking Sector and the Foreign Currency Flow of a Country

There are several reasons as to why countries open up the banking sector. Some governments opened their banking markets in the hope that foreign buyers would participate in the privatization of state-owned banks and help push up prices. Others did so in exchange for trade concessions at multilateral trade negotiations or to comply with accession requirements of the WTO (Diaz, 2007).

Generally, there are two arguments about how foreign banks affect the foreign currency flow of the host country. On one hand, those who believe foreign banks have a positive impact on the host country's foreign currency stressed that; foreign banks bring more foreign currency to the country.

According to Schmukler (2004) recent crises have heightened the importance of foreign capital to finance government budgets and smooth public consumption and investment. Also, foreign capital has helped governments capitalize banks with problems, conduct corporate restructuring, and manage crises. On the other hand, others argue that foreign banks will not increase foreign currency inflows and help a country to have more reserves. And worse they might decrease the foreign currency flowing into the country which can affect the country's economy at large.

During an economic crisis in the host country, foreign-controlled banks will behave in a way that mitigates or exacerbates the shock. Because their parent institution is based abroad, a foreign bank should be able to inject liquidity into the banking system even when domestic banks are embroiled in the crisis and are forced to cut back their lending.

Foreign banks could, in theory, act as lenders of last resort. Yet, because foreign banks operate their subsidiaries in the context of a global strategy, sometimes the parent institution may make decisions that are good for the parent but bad for the branch or subsidiary in the host country. This can exacerbate the shock. Host-country regulators also fret that, ultimately, a parent bank is under no legal obligation to rescue its troubled subsidiary and will walk away from it if the situation deteriorates. Domestic banks, on the other hand, cannot exit (Diaz, 2007).

The benefits and risks of liberalizations have been discussed by many scholars. Financial liberalization minimizes the government's role in the financial sector letting market forces independently determine the ways and areas of resources' distribution in that sphere. Banking market liberalization is a crucial part of financial liberalization (Kladova et al., 2012). Bezabeh and Asayehgn (2014) Barriers to entry in the banking sector reinforce inefficient state - owned enterprises by shielding them from competition.

Liberalization of the financial system more generally may also have implications for capital flight, but as in the case of capital account openness, the impact cannot be determined a priori. On the one hand, financial liberalization can be expected to reduce the rate-of-return differential between economies as a result of increased capital mobility. This would reduce simple profit driven capital flight. On the other hand, financial liberalization may open additional opportunities for unrecorded financial transactions, which could increase capital flight (Ndikumana et al., 2014).

Financial liberalization can have both positive and negative impacts. On the one hand, financial liberalization policies may increase the risk-adjusted return on domestically invested capital compared to investment held abroad. Moreover, financial liberalization may be seen as a credible signal of the government's commitment to sound economic management, leading to improved domestic policy making, reduced policy uncertainty, and enhanced institutional quality. If this is the case, financial liberalization leads to reduced capital flight. On the other hand, however, with financial liberalization, capital may flow abroad more easily. If individuals have incentives to hold their wealth abroad, then financial liberalization makes it easier to allocate capital outside the country (Hermes and Lensink, 2014).

According to the IMF (2012) a country has to consider the relative strength of its local banks and the consequences due to the complexity of the system following liberalization. It is important to further strengthen domestic financial sectors. The development and deepening of local capital and bond markets can help absorb capital flows and deal with their volatility, direct them to productive activities in the real sector, promote growth and development of the local economy, and maintain a financing base in case of international financial turmoil.

In strong competitive economies where capital inflows are vibrant, the liberalization of the capital account can lead to continued inflows of foreign exchange. In less competitive economies, particularly where there is the expectation that the exchange rate cannot be maintained, liberalization of the capital account can lead to outflows of foreign exchange. Jamaica experienced this for several decades. Indeed, following the South-East Asian crisis of the mid nineties, Malaysia re-imposed exchange controls in order to pre-empt short term outflows, to staunch the outflow of capital and to rebuild reserves (Williams, 2005).

It is worth highlighting that foreign banks have several investment opportunities outside the host country, so they may easily reallocate local funds abroad in search of better investment opportunities, especially when conditions of the host country worsen. In such a way, they facilitate the flight of capital. Branches or subsidiaries of foreign banks may also make it easier to move abroad illegally acquired local funds. Episodic evidence, indeed, shows that some branches or subsidiaries of foreign banks in Africa have been used by dictators or corrupt government officials to divert illicit funds to accounts in Western economies and tax havens (Massa, 2014).

According to Bayraktar and Wang, (2004) foreign bank entry may cause an additional problem if a country liberalizes its domestic financial sector first. Since foreign banks do not have an access to longer term investment instruments when they are first involved in the domestic banking sector, they will provide shorter-term funds. This may affect the health of the banking sector negatively, thus the efficiency gain of domestic banks.

Bezabeh and Asayehgn (2014) analyzed the pros and cons of opening up Ethiopia's banking sector to foreign banks. Foreign banks have a number of advantages compared to domestic banks. By servicing client's active in more than one country, they can achieve benefits from spreading best practice policies and procedures. Second, they may be able to diversify risk better, allowing them to undertake higher risk, but also with potentially higher returns on investments. Third, foreign banks have advantages in the form of more diversified funding sources, including having access to external liquidity from their parent banks, which may lower their funding costs. Finally, by being larger they may achieve other scale advantages such as utilizing more advanced and sophisticated risk assessment models to give them a competitive edge over fragile Ethiopian banks.

2.4 When to Liberalize the Banking Sector

Allowing foreign banks without carefully understanding the global environment can also have serious consequences. If the right financial infrastructure is not in place or is not put in place during integration, liberalization followed by capital inflows can debilitate the health of the local financial system. If market fundamentals deteriorate, speculative attacks will occur with capital outflows from both domestic and foreign investors (Schmukler, 2004).

Assuming that foreign banks have an easier access to international funds, the most important effect of foreign bank entry would be that they provide additional funds to the domestic banking sector. But if capital accounts are liberalized first in an economy, it is not an expected outcome of foreign bank entry. The reason is that both foreign and domestic banks will have an easy access to international capital markets. So it would be expected that the share of foreign banks may not affect the efficiency of domestic banks a lot (Bayraktar and Wang, 2004).

2.5 Regulation, Supervision and Liberalization

The entry of foreign banks through financial liberalization may improve bank supervision through regulatory spillover. Adjustment measures and regulatory monitoring of foreign bank branches, subsidiaries, and Greenfield investments are essential in permitting foreign financial FDI. (Kiyota et al, 2007). Levine (2014) also added that easing restrictions on foreign banks is likely to create domestic pressures in developing countries to harmonize bank regulatory and supervisory procedures and standards with those of developed countries.

After conducting a study on Pakistan's financial reform and its economic growth Waheed (2009) concluded that a more efficient financial system provides better financial services and this enables the economy to grow faster. On the other hand, a weak financial system spills over unfavorable into the economy. An inadequately supervised financial system may be crisis prone, with potentially negative effects on the sector. Thus, the financial sector requires special attention of the policy makers.

Regulatory and supervision capacity is very important in order for a country to benefit from financial liberalization. Galindo et al (2002) presumably, economies that afford weak legal protections to creditors are less likely to benefit from liberalization. If these protections are not in place the liberalization of restrictions on intermediation are dampened by the adverse effects of institutional disarrays and do not promote financial sector development. The absence of legal protections that guarantee the ability of creditors to minimize their financial loss in case of borrower default can counteract the potential efficiency effects that financial liberalization can induce.

In a study of six banks from emerging European economies namely, Romania, Czech Republic, Hungary and Poland (Beju et al, 2012) concluded that too rapid liberalization in a country does not mean speed problems in an absolute sense, but in a relative sense: in many cases instability occurred because of the difference between impressive speeds of financial liberalization and very slow adjustment of the prudential provisions, banking and financial regulations, respectively monetary policy actions.

(Angkinand et al, 2010) analyzed the relationship between liberalization and banking crisis and argued that liberalization by its self will not bring economic crisis. He further added the importance of regulation for a country to benefit from liberalization. The common view that financial liberalization leads to an increase in the likelihood of banking crises is not robust. This commonly observed relationship may be the result of a lack of overt financial crises in countries with severely repressed financial, government controlled and subsidized financial system.

Taking the interaction between strength of capital regulation and supervision, and financial liberalization into account, financial liberalization reduces the likelihood of banking crisis except in countries with the weakest regulation and supervision. Thus, stronger regulation and supervision enable countries to obtain benefits of financial liberalization in terms of growth as well as reduced likelihood of banking crisis.

2.6 Entry Mode of Foreign Banks

Foreign banks entry might also affect credit availability for small or opaque firms. Research suggest that although large firms might be the most benefited from foreign bank presence, small firms are not damaged in spite of business strategies of small/newly established foreign banks subsidiaries which attend mostly corporate customers.

Muchina (2011) analyzed Ecobank's entry mode in Africa. Ecobank considered several foreign market entry strategies into Kenya including direct investment which the bank found to be too costly and too risky. This was especially so because the bank was to set up its distribution network and offices and it would take longer for the bank to reach out to the customers. The other alternative sought by Ecobank in entering the Kenyan market was acquisition of a local bank. This involved weighing the advantages and disadvantages of losing some control to the acquired shareholders.

In a study conducted by taking a sample of 63 banks from 18 countries in 2004; Belaounia et al, (2016) pointed out the determinants for a bank entry mode. The parent bank's choice of region does not lead to a specific market-entry mode, and vice versa. In addition, the stricter regulatory framework in Africa appears to be a significant factor in attracting foreign banks. Changes in the tax system appear to account for the shift from the Middle East and Latin America to Southeast Asia, while an increased country-risk appears to account for the shift from Southeast Asia to Eastern Europe, the Middle East and Africa.

Regarding the characteristics of the parent bank, large banks are more likely to establish themselves overseas through branches while those with the greatest experience of internationalization are more likely to have no preference between subsidiaries and branches. A common official language tends to favor entry in Africa and to favor the subsidiary as the foreign-market-entry mode. Finally, the size of the bank and its experience of internationalization are not significant determinants of location choice.

A company's strategy to enter a market is pertinent for success. By investigating the relationship between entry strategy and success of KCB bank in East Africa, Ngetich (2010) explained that in Southern Sudan for instance the employment of Sudanese has endeared the customers to feel KCB as part of their own while KCB foundation donation in Zanzibar sparked the demand for KCB products as it was seen to be interested in the welfare of the people of Zanzibar and not merely profit. KCB inability to turnaround its investment in Tanzania was because it failed to create a service niche and neither did it cut it price to penetrate this market. They went further to claim that the lack of exit strategy had made it difficult to move out of Tanzania even after years of persistent losses.

In another study Muchina (2011) assessed entry strategy of Ecobank in Kenya. Ecobank considered several foreign market entry strategies into Kenya including direct investment which the bank found to be too costly and too risky. This was especially so because the bank was to set up its distribution network and offices and it would take longer for the bank to reach out to the customers.

The other alternative sought by Ecobank in entering the Kenyan market was acquisition of a local bank. This involved weighing the advantages and disadvantages of losing some control to the acquired shareholders. However the advantages assessed showed that this strategy would be more viable than direct investment by the Bank. The advantages included warm reception by the customers and regulators on the financial industry in Kenya. As opposed to direct investment, acquisition posted the advantage of local acceptability and riding on the existing bank's market share. As a result, the advantages of this strategy outweigh the disadvantages. The bank therefore picked on this strategy to enter the Kenyan financial market.

2.7 Why Ethiopia's Government Oppose Liberalization?

The Ethiopian leadership does not reject the role of the private sector, but they do oppose letting the global "markets allocate resources" when it comes to the survival of their nation. Rather, they believe that the state has a primary responsibility to intervene to provide financing for critical categories of infrastructure and other essential areas of investment that promote their developmental strategy (Freeman, 2016).

Bezabeh and Asayehgn (2014) the government's concern is that if foreign banks were to be allowed to operate in Ethiopia, it may lose of control over the economy. This position is based on the infant industry argument. Prohibiting foreign bank entry at this time would prevent the domestic banks from being weakened because of unfair competition from foreign banks.

Kiyota et al. (2007) identified the main reasons for the refusal of Ethiopian government to open up its banking sector to foreigners. In the case of Ethiopia, the Prime Minister and his government, as key stakeholders, have five main concerns, many of which are shared by other stakeholders, including the leadership of the private banks and the Ethiopian Bankers' Association:

• The government believes 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).

• Ethiopian government officials also 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.

• 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.

• There is concern 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.

• Finally, it is strongly believed that the authorities will be unable at present to regulate and supervise foreign banks effectively.

2.8 Empirical Literature on Liberalization of Banking Sector

2.8.1 Trends in Foreign Bank Ownership

Claessens and van Horen (2011) show the trend in which more countries are opening their banking sector. While 19 countries did not have any foreign bank present in 1995, only 11 countries (Cuba, Ethiopia, Haiti, Iceland, Iran, Libya, Oman, Qatar, Saudi Arabia, Sri Lanka and Yemen) remained without any foreign bank in 2009.

Citing Beck et al. (2014); (Cull et al, 2017) stated that in Sub-Saharan Africa, foreign-owned banks have been present since the colonial era and their participation increased following reforms that liberalized financial sectors in the 1990s and early 2000s. In particular, the median share of assets held by foreign-owned banks rose from 34 percent in 1995 to 66 percent in 2008. In 2010, the region had the highest median foreign bank share (73 percent) and lowest median government bank share (8 percent) in the developing world. The fast expansion of banks from developing countries in particular Pan-African banks headquartered in South Africa, Nigeria, Morocco, Kenya and Togo.

2.8.2 Reasons for Financial Liberalization

Driven by domestic deregulation, including the removal of entry barriers, technological advances allowing for easier telecommunication, increased financial integration, and more generally heightened globalization, the relative importance of foreign banks has increased substantially in many countries (Claessens and van Horen, 2011).

The financial liberalization that took place in the developing countries in the 1980s and 1990s was part of the general move toward giving markets a greater role in development. It was also a reaction to several factors specific to finance: the costs, corruption, and inefficiencies associated with using finance as an instrument of populist, state-led development; a desire for more financial resources; citizens' demands for better finance and lower implicit taxes and subsidies; and the pressures exerted on repressed financial systems by greater international trade, travel, migration, and better communications (Hanson and Ramachandran, 2005).

Countries such as Korea among other reasons push liberalization as a result of trade and financial conflict with other countries. Accusing Korea of "manipulating" its exchange rate, the United States demanded that Korea advance its trade and financial liberalization programs and make the liberalization programs more transparent (Park, 1996).

Citing Shaw (1973), Uche (2011) explains why developing countries oppose liberalization. Financial repression has been popular in developing countries for three main reasons. First, there is a natural instinct in such countries to prohibit usury. Arguably the best known proponent of this view is Maynard Keynes who argued that interest rates are not self adjusting at a level best suited for the social advantage but constantly tends to rise too high. It is therefore necessary for governments to curb it by statute or custom. A second reason for the popularity of financial repression in backward countries is the general belief that such countries do not have the discipline to control their nominal money. This makes it impossible for financial deepening to take place in such economies. The third reason for the popularity of financial repression in developing countries is the widespread belief that financial deepening is an ineffective developmental strategy because it is expensive in terms of scarce factors of production. Specifically it is argued that backward countries do not have the requisite skills or regulatory structures to police such liberalized financial systems.

According to Gupta et al, (2011) the objectives of the liberalization agenda of India's banking sector were both to increase the operational efficiency of banks at the institution level and to improve the efficacy of resource allocation economy-wide.

In the past decade, most Asian economies, including Japan, have initiated economic policies to gradually dismantle the Japanese financial regime. In most cases the reforms were forced on the government by conflicts between the rigidly regulated financial systems and the new economic, political, and technological environment that began to emerge in the 1970s. The new economic environment was characterized by variable and uncertain rates of inflation and changing patterns in the flow of funds. The new political environment stressed the benefits of the market system and the failures of socialism. Advances in computer and telecommunications technology provided a new technological environment that increased the efficiency and availability of financial services and assets (Cargill and Parker, 2001).

2.8.3 Stages of Liberalization

Malaysia began her path to financial liberalization on October 1978. Interest rates were deregulated to promote a more liberal and competitive financial system. However, on several occasions, the deregulation process had to be put on hold or reversed when the economy faced adverse shocks. Malaysia's banking sector is considered fully liberalized on February 1991, where each commercial bank can set its own base lending rate according to its own cost of funds (Yee and Tan, 2008).

Park (1996) explains how Korea's financial sector is liberalized through the years. Financial deregulation commenced with the removal of various restrictions on bank management and the privatization of commercial bank ownership in the early 1980s. Regulations on commercial banks in the spheres of the organization, budget, branching, and business practices were greatly loosened. During 1981-83, the government sold its shares in all nationwide commercial banks. To prevent bank ownership from being concentrated among Korea's large conglomerates, the chaebol, ownership by a single shareholder was restricted to 8 percent of the total. The government also chartered two joint venture commercial banks with Korean and foreign partners and loosened regulations on chartering nonbank financial institutions (NBFIs) such as investment, mutual savings, and finance companies. In addition, it has continued to broaden and diversify services supplied by financial institutions.

The significant step toward financial opening was taken in 1991. Effective from January 1992, foreigners are allowed to purchase Korean stocks, up to 3 percent of the outstanding shares of each company for each individual; no more than 10 percent of a company may be foreign-owned, however. The government also authorized the operation of foreign securities companies in Korea.

Having had several discussions since 1989, both parties agreed to set out the three-stage Blueprint for the Liberalization and Opening of the Financial Sector. The first-stage and second-stage blueprints were announced in March and June 1992, respectively. Extending these, the third-stage blueprint was announced in June 1993. The third-stage blueprint covers crucial areas such as interest rate liberalization, control of bank loans to chaebols, short-term finance, and foreign exchange and capital account liberalization. The third-stage blueprint was the cornerstone for Korea's financial liberalization. It aims to achieve substantial liberalization of Korea's financial sector by 1997.

Murillo (2007) explains how liberalization led to financial crisis in Mexico. At the end of the administration of President López Portillo, in 1982, Mexico experienced its most severe crisis since 1932, with real gross domestic product (GDP) declining by 4.7 percent in the fourth quarter of 1982. The crisis was triggered by adverse shocks to oil prices and world interest rates, but was ultimately caused by a disorderly expansionary fiscal policy largely supported by borrowing from international capital markets and by borrowing from the central bank (i.e., simply printing money to finance the deficit), which the government had followed since the 1970s. The government devalued the currency and defaulted on foreign debt payments, which caused Mexico to lose access to international credit markets.

In September 1982, the government also announced a decree to amend the constitution and nationalize 58 of the 60 banks in the sector with the exceptions Citibank, which has had a presence in Mexico since 1929, and Banco Obrero, which was owned by a labor union.

Starting in 1988, a new series of reforms were initiated to make the financial system more competitive. Among these reforms was the elimination in April 1989 of controls on interest rates and the sectoral quotas imposed by the government on commercial lending. In July 1990, the government passed laws allowing for the formation of integrated financial groups that could consolidate different types of financial intermediation under a scheme of universal banking. In August of 1990, the finance ministry announced the principles that would inspire the privatization process. Two of the goals of the program were to increase competition and efficiency in the financial system and to improve bank capitalization.

Citing Unal and Navarro (1999); despite the recent reforms, the new banks operated under an outdated regulatory environment and that the supervisory agencies were often unable to implement newly adopted regulations or to enforce existing rules. Induced by the lack of an appropriate legal and regulatory environment, banks had been engaged in risky lending practices almost immediately after the privatization process was concluded and past-due loans had been rising dramatically prior to the devaluation. Citing Gil-Díaz (1998) from December 1988 to November 1994Credit from local commercial banks to the private sector rose in real terms by 277 percent, or 25 percent per year.

Citing Gruben and McComb (2003) nonperforming loans, however, grew even faster. Between December 1991 and December 1993 alone, gross past-due loans more than tripled in absolute terms, while the share of reported nonperforming loans to total loans rose from 4.13 to 7.26 percent. This situation persisted into the bailout episode that followed.

Liébana (2001) points out the major policy decisions that led to financial liberalization in Peru. The start of the financial liberalization process was marked by three policy decisions at the outset of the stabilization program:

• Financial institutions were authorized to create accounts and loans denominated in foreign currency (1991).

• Controls on the capital account started to be liberalized (March 1991). Not all controls were removed immediately because the magnitude of the potential outflows was unknown, while the stock of net international reserves was negative (US$163.1 million at the end of July 1990).

• The maximum interest rates were not re-adjusted. The last adjustment, on July 1, 1990, had set the maximum lending rate at 42.5% per month. Given that policy makers expected a quick disinflation, the lack of a change in the interest rate implied a decision to free interest rates, as the ceiling would become ineffective if the program yielded the expected results.

2.8.4 Regulation and Financial Liberalization

Citing Mishkin (2007), Giz (2013) article stressed the need of strong regulatory capacity before financial liberalization in order to achieve an economic growth parallels with financial stability. Compared to the Asian countries that faced financial difficulties during the Asian Financial Crisis in the late 1990s; Singapore, Hong Kong and Taiwan, which were less affected by the crisis, all had strong prudential16 and regulatory systems. In South Korea however, rapid globalization had allowed domestic banks to borrow abroad at a stage when Korean regulators had not yet acquired the requisite skill set. As a result there was poor screening and monitoring of borrowers, and moral hazard lead to excessive risk taking by bank managers.

The article of Giz (2013) also cites Kablan (2010) which analyzes how Africa non-performing loans have affected the efficiency of African banks. Vetting at entry and continuous monitoring and supervision of all participants is therefore crucial to avoiding the introduction of systemic risk. This is a factor recognized in the GATS where liberalization commitments do not negate a government’s right to take steps to maintain prudential measures that are designed to ensure the stability and integrity of the financial system and protect investors and depositors.

Abbas and Malik (2010) explain how building supervision capacity played an important role in reforming Pakistan’s financial sector. Banking supervision was suffering from various problems before the introduction of banking sector reforms of 1990s. The role of SBP, which had the main responsibility to supervise the banking system, was marginalized as it faced inadequacy of banking supervision capacity. With the grant of autonomy to the SBP in 1993, abolition of the PBC, and changes in the BCO, the SBP devised a strategy to consolidate banking supervisory functions. It also issued separate Prudential Regulations for commercial banks, SMEs, agriculture, microfinance, and infrastructure. Further, loan recovery process was further streamlined by issuing clear guidelines for loan classification and requiring banks to submit regular reports on recoveries.

Years of bank operations under the state-owned structure and under regulation of banks are identified as the key factors behind uncompetitiveness, inefficiency, and vulnerability of banks.

Dual supervision of banks and poor regulatory controls are indicated as the major factor behind weak financial health of banks. Overregulation of banks also impacts competitiveness, efficiency and financial health of banks (ibid).

2.8.5 Financial Structure after Liberalization

Besides the difficulties resulting from external financial liberalization (or rules applying to flows of foreign capital into the country and the repatriation of capital and the returns associated with such flows), there are a number of adverse macroeconomic effects of what could be termed internal financial liberalization, necessitated in large part by the effort to attract portfolio and direct foreign investment. Financial liberalization of this kind being adopted in India not only results in changes in the mode of functioning and regulation of the financial sector, but in a process of institutional change. This process of institutional change implies that the role played by the pre-existing financial structure, characterized by the presence of state-owned financial institutions and banks, is substantially altered (Chandrasekhar, 2011).

During the liberalization period a more liberal entry of private and foreign banks was allowed, as a result of which the total number of banks in the industry increased and the ownership structure of the Indian banking sector changed somewhat in the first few years post liberalization. Due to the entry of new banks, the number of private sector banks first increased in the mid-1990s, but since then the number has declined due to mergers or closures. The number of foreign banks increased steadily through the 1980s, and mid 1990s, and then declined. The total number of banks peaked at 105 in the mid-1990s but by 2007 the number had declined to 82, which was only marginally higher than their number in the early 1990s when liberalization had started (Gupta et al, 2011).

2.8.6 Pros and Cons of Financial Liberalization

Proponents of financial liberalization believe that deregulation would bring about a host of benefits which would boost economic growth; among them, improving the efficiency and performance of the financial system, product innovation and lower prices. However, in the last three decades, we have witnessed the pitfalls that a liberalized regime could bring. Amongst them are increased use of credit to purchase assets and finance consumption, asset price inflation and volatility and financial fragility (Yee and Tan, 2008).

Claessens and van Horen (2011) concludes that foreign banks that foreign banks had somehow contributed to the global financial crisis which took place from 2007 – 2009 on average foreign banks reduced lending more compared to domestic banks during the global crisis. As such, foreign banks arguably contributed to financial instability. Important heterogeneity exists, however, some of which we document. When dominant in a banking system, foreign banks turned out to be a more stable source of credit compared to domestic banks. And foreign banks that generated an important part of their funding from local deposits were much less likely to reduce lending.

Key banking reforms remain helpful in correcting flaws in the banking sector of Pakistan. In particular, privatization of banks, the deregulation and institutional strengthening measures and switching towards market-based monetary and credit management remain helpful in correcting the prevailing flaws (Abbas and Malik, 2010).

In Philippines, following the signing of a banking reform bill in 2014; which allows full control of domestic lenders by foreign banks, foreign banks are allowed to acquire, purchase or own up to 100% of the voting stock of an existing Philippines bank, from 60% previously, invest in up to 100% of the voting stock of new banking subsidiary, establish branches with full banking authority and limits to the number of foreign banks operating in the country have been eliminated. Deorukhkar et al, (2014) argued that the pros outweigh the cons.

Against this backdrop, we evaluate the implications of the latest banking sector liberalization measures on the Philippines economy, on potential foreign bank entrants and on local domestic banks. We believe that the medium to long term benefits to - 1) the Philippines economy from a vibrant banking sector, 2) foreign lenders, looking expand their footprints in fast growing emerging economies, and 3) the domestic banks, looking to catapult into the big league, - far outweigh the short term painful adjustments that may take place as the Philippines economy and its lightweight banking sector is exposed to foreign banking heavyweights. Thus, we believe that the Government's bold banking reforms are a win-win situation for all its stakeholders over the long haul (ibid).

The stability of earlier period contrasts with the sizeable increase in the number of failures in the later period, in which the sector has been liberalized and competition has been liberalized and competition has been introduced. Citing Demirguc – Kunt and Detragiache (1990), Vive (2001) stressed that liberalization as one of the factors, together with inadequate macro policies, adverse macro shocks, and vulnerability of the foreign sector that explains the banking crisis. However, the fact that the effect of liberalization is weaker in a ‘strong’ institutional environment (for example, in terms of the rule of law and contract enforcement) points to inappropriate regulation that accompanies liberalization as aggravating crises. This is consistent with banking crises in diverse places such as the USA, Scandinavia and Spain.

Reputable international banks have entered many countries in recent years, but losses and, in some cases, their own lack of capital have limited their interest in further expansion. Some banks that expanded in Eastern Europe, in hopes of establishing a presence before countries acceded to the European Union, suffered losses as competition developed. Some that expanded in Latin America have suffered losses from operations and from the developments in Argentina. In the recent re-privatizations of Indonesian banks, only one bid came from a well-known global bank. Lesser-known banks have been expanding internationally, but such banks can generate more supervision problems than local banks, because of the problems with international supervision. Moreover, without reputations to lose, such banks may pull out when things go bad in the country or in their home market, leaving governments to bear the costs (Hanson and Ramachandran, 2005).

Following the failure of indigenous banks in 1952 and 1953, in 1972 the Nigerian Government decided to indigenize foreign banking operations in the country. The reason given for this was in order to help fund its wider interests in indigenizing several foreign businesses. By, 1976, the Federal Government had acquired controlling shares in all foreign banks in the country. This certainly did not augur well for the proper development of the financial system. Rather, it decimated the ability of these commercial banks, which are naturally allergic to inflation, to serve as a check on government fiscal indiscipline and their inflationary consequences. Government control of majority of the commercial banks therefore oiled financial repression.

Citing Uche (1997) and (2010) it was however not until 1986 after the Nigerian economy began to show serious signs of weaknesses that the government under pressure from the IMF and the

World Bank decided to introduce a Structural Adjustment Programme (SAP) and deregulate the Nigerian economy. Financial liberalization was central to this programme. For instance, the main strategies of the programme were: the adoption of a market determined exchange rate for the Naira, the deregulation of external trade and payments arrangements and reductions in price and administrative controls. A consequence of the above measures was the phenomenal increase in the number of financial institutions in operation in the country. The number of commercial and merchant banks, for instance rose from 41 in 1985 to 120 in 1993.

Unfortunately, financial liberalization failed to achieve its anticipated benefits in Nigeria. Rather it led to financial fragility and financial system distress. In 1998 alone, for instance, 26 banking licenses were withdrawn by the Central Bank of Nigeria (Ogowewo and Uche, 2006).

It is however important to note that the Nigerian banking system was even after financial liberalization, still dominated by local banks. The failure of banking liberalization therefore had little to do with foreign banking operations and more to do with the inability of the Government to adhere to any form of fiscal discipline and provide a stable macroeconomic environment for such liberalizations to yield positive economic results (Uche, 2011).

Ghosh (2005) analyze how financial liberalization benefited developing countries and the negative consequences it brought. The proximate explanation for the wave of financial liberalization in the developing countries is that this pyramidal growth of finance, which increased the fragility of the system, was seen as an opportunity. Enhanced flows to developing countries, initially in the form of debt and subsequently in the form of debt and portfolio investments led to two consequences. First, the notion of external vulnerability which underlay the interventionist strategies of the 1950s and 1960s no longer seemed relevant – after all any current account deficit could be financed, it appeared, as long as such capital inflows were assured. Second, growth was now easier to ensure without having to confront domestic vested interests, since international liquidity could be used not merely to finance current and capital expenditures but also to ease any supply side constraints that would otherwise constrain such growth.

On the otherhand, Ghosh (2005) explained the downsides of financial liberalization in developing countries. Financial liberalization has resulted in an increase in financial fragility in developing countries, making them prone to periodic financial and currency crises. These relate both to internal banking and related crises, and currency crises stemming from more open capital accounts. The origin of several crises can be traced to the shift to a more liberal and open financial regime, since this unleashes a dynamic that pushes the financial system towards a poorly regulated, oligopolistic structure, with a corresponding increase in fragility.

Iceland would not have become a symbol of the global credit crunch if it had remained a passive recipient of the global saving glut. The collapse of its financial system can be traced to the privatization of its banking system and its expansion into other countries and the borrowing by the banks to finance the buying of foreign businesses by their owners. The privatization of the banks in a setting of capital mobility in a formerly repressed financial system with very limited experience of modern banking practices set the stage for the subsequent development (Halldorsson and Zoega, 2010).

Cull et al. (2017) explained how foreign banks can benefit the host country and also derail the host country's economy in the reverse. Foreign-owned banks tend to be more efficient than domestic banks in developing countries, typically promote competition in host country banking sectors, and help stabilize credit when host countries face idiosyncratic shocks. But, as highlighted in recent research since the GFC, there are trade-offs since foreign-owned banks can also transmit external shocks. In addition, they might not always contribute to expanded access to credit. But context matters. Access to credit increases with the level of competition in the banking sector when foreign banks entered and with a country's level of institutional development. And the negative relation between foreign bank presence and credit levels found in some papers could stem, in part, from the fact that foreign banks were brought in to recapitalize failing banking sectors.

Overall, there is little evidence that government bank ownership provides substantial benefits (relative to other types of ownership) to the banking sector, the real economy, or users of banking services, especially in developing countries. While there is some recent evidence that government-owned banks can help stabilize credit growth during crises, in general, they have had a negative impact on competition and banking performance and their record in expanding access to credit is, at best, mixed (ibid).

Chapter Three

Research Methodology

3.1 Research Approach and Design

3.1.1 Research Design

Research design is a choice of an investigator about the components of his project and development of certain components of the design (Singh, 2006). According to Saunders et al. (2009) a research design will be the general plan of how you will go about answering your research question(s). It will contain clear objectives, derived from your research question(s), specify the sources from which you intend to collect data, and consider the constraints that you will inevitably have (e.g. access to data, time, location and money) as well as discussing ethical issues.

According to Kothari (2004) research conducted to gain familiarity with a phenomenon or to achieve new insights into it (studies with this object in view are termed as exploratory research studies. Exploratory studies are undertaken to better comprehend the nature of the problem since very few studies might have been conducted in that area. Extensive interviews with many people might have to be undertaken to get a handle on the situation and understand the phenomena (Sekaran, 2003).

Since the research topic is not extensively studied and the researcher's aim is to understand the implications of the policy related to the foreign currency circulation of the country, the researcher has chosen the nature of the research to be exploratory.

The implications of the government's policy not to allow foreign banks in the country on the foreign currency flow of the country was analyzed from different perspectives; specifically, from the perspective of government regulation and the country's economic potential. The study also analyzed the willingness of foreign banks to provide liquidity in terms of foreign currency given the country's current economic and political status.

3.1.2 Research Approach

Research approaches are plans and the procedures for research that span the steps from broad assumptions to detailed methods of data collection, analysis, and interpretation (Creswell, 2014). Qualitative research is a research strategy that usually emphasizes words rather than quantification in the collection and analysis of data (Bryman et al., 2010). Qualitative approach to research is concerned with subjective assessment of attitudes, opinions and behavior. Research in such a situation is a function of researcher's insights and impressions (Kothari, 2004).

Qualitative business research is research that addresses business objectives through techniques that allow the researcher to provide elaborate interpretations of market phenomena without depending on numerical measurement. Its focus is on discovering true inner meanings and new insights. When the emphasis is on a deeper understanding of motivations or on developing novel concepts, qualitative research is very appropriate. (Zikmund et al, 2012). This study requires in depth understanding of the matter since it is a macro level policy analysis. As a result, the research approach of this study is qualitative.

3.2 Population and Sampling

3.2.1. Population

A population is all the individuals or units of interest (Hanlon and Larget, 2011). Population is the full universe of people or things from which the sample is selected (Greener, 2008). Since the research is a policy level analysis individuals, institutions and groups that are knowledgeable in the area and have the capacity to provide important inputs to the study were targeted as population.

These institutions and groups include; foreign bank representative offices, bank managers, economists from National Bank of Ethiopia, Ethiopian Economics Association, National Planning Commission, Ministry of Finance and Economic Cooperation. And from International financial institutions, economists of the World Bank were considered as a population in this study.

3.2.2. Sampling

A sample is a subset of the individuals in a population; there is typically data available for individuals in samples (Hanlon and Larget, 2011). Because researchers may not be able to study the entire population of interest, it is important that the sample be representative of the population from which it was selected (Marczyk et al, 2005).

In quantitative research, randomization is used to avoid bias in the selection of a sample and is selected in such a way that it represents the study population. In qualitative research no such attempt is made in selecting a sample. You purposely select 'information-rich′ respondents who will provide you with the information you need. In quantitative research, this is considered a biased sample (Kumar, 2011). There are different types of sampling techniques. In this study samples are drawn from the population based on purpose.

Purposive sampling is a sampling technique one uses his or her own judgment to select a sample. It's often used with very small samples and populations within qualitative research, particularly case studies or grounded theory (Greener, 2008). Thus, for this study individual; mostly economists from different institutions that are knowledgeable in macroeconomics, finance as well as banking and Ethiopia's banking industry were chosen.

From National Bank of Ethiopia the Monetary and Financial Analysis Directorate is selected. National Planning Commission (NPC) is another institution which sample is taken. One of the goals for the institution is ensuring structural economic transformation in the country. Thus, NPC is included in the sample. Ministry of Finance and Economic Cooperation (MoFEC) is also another institution from which sample is taken as its main objective is to push for changes for the development of the economy.

Since the study directly aims at the Ethiopian Banking sector, sample is also taken from banks as well. A branch manager from Awash bank and an economist from Eco Bank were included in the sample. Researchers regarding the Ethiopian economy are essential for this study. They can provide information that is important for in depth analysis. To include the explanations of the researchers and due to the fact that the study emphasizes on the Ethiopian economy and its banking sector, researchers from the Ethiopian Economists Association were also included.

By taking samples from different institutions the researcher has tried to maintain institutional diversity. Thus, the researcher has not relied on the opinion of one or two institutions. Hence, bias is avoided.

3.3. Data Sources and Data Collection Methods

3.3.1. Data Sources

Data come in two main forms, depending on its closeness to the event recorded. Data that has been observed, experienced or recorded close to the event are the nearest one can get to the truth, and are called primary data. Written sources that interpret or record primary data are called secondary sources (Walliman, 2011). For this study the sources of data are both primary and secondary.

In this study data primarily gathered though semi- structured interview. Secondary data is the data that have been already collected by and readily available from other sources. Such data are cheaper and more quickly obtainable than primary data and also may be available when primary data cannot be obtained at all (Juneja, 2018). Government publications, websites, books, journal articles, internal records etc. are secondary data collection sources (Ajayi, 2017).

In this study reports by the National bank of Ethiopia, World Bank and IMF, articles, books, websites and other literatures related to the topic were used as a source of secondary data.

3.3.2. Data Collection Methods

The interview method of collecting data involves presentation of oral-verbal stimuli and reply in terms of oral-verbal responses (Kothari, 2004). With semi-structured interviews, the interviewer still has a clear list of issues to be addressed and questions to be answered. However, with the semi-structured interview the interviewer is prepared to be flexible in terms of the order in which the topics are considered, and, perhaps more significantly, to let the interviewee develop ideas and speak more widely on the issues raised by the researcher. The answers are open-ended, and there is more emphasis on the interviewee elaborating points of interest (Denscombe, 2007).

Predetermined questions, but order can be modified based upon the interviewer's perception of what seems most appropriate. Question wording can be changed and explanations given; inappropriate questions for a particular interviewee can be omitted, or additional ones included (Teijlingen, 2014).

Taking into consideration the fact that the population is knowledgeable in the subject matter and not to limit the discussion with in the level of knowledge of the researcher, semi - structured interviewing technique was used in gathering primary data. In addition to this, semi - structured interview will enable free flow of ideas which would invite the interviewee bring his or her knowledge on board.

3.4. Data Analysis Method

Data analysis is the application of reasoning to understand the data that have been gathered. In its simplest form, analysis may involve determining consistent patterns and summarizing the relevant details revealed in the investigation (Zikmund et al, 2012). The analysis of qualitative data is often one step in a series of steps throughout the research process. It comes after field access has been found, sampling decisions have been taken, data have been collected, recorded and elaborated (Flick, 2013).

Qualitative data analysis involves organizing, accounting for and explaining the data; in short, making sense of data in terms of the participants' definitions of the situation, noting patterns, themes, categories and regularities (Cohen et al, 2007).

According to Creswell (2014) qualitative data can be analyzed following series of steps.

Step 1. Organize and prepare the data for analysis. This involves transcribing interviews, optically scanning material, typing up field notes, cataloguing all of the visual material, and sorting and arranging the data into different types depending on the sources of information.

Step 2. Read or look at all the data.

Step 3. Start coding all of the data. Codes are labels or tags used to allocate units of meaning to the data, going beyond the simple physical facts. Coding helps you to organize your piles of data and provides a first step in conceptualization and helps to prevent ‘data overload’ resulting from mountains unprocessed data (Walliman, 2011).

Step 4. Use the coding process to generate a description of the setting or people as well as categories or themes for analysis.

Step 5. Advance how the description and themes will be represented in the qualitative narrative.

Step 6. A final step in data analysis involves making an interpretation in qualitative research of the findings or results.

The researcher followed the six steps mentioned above and analyzed the data. First the researcher prepared all the data for analysis. Then, by carefully reading all of the respondents’ opinions, the data is placed in different categories. From the ideas which the respondents discussed, the researcher identified themes on which analysis is made.

In the process; the prohibition of foreign banks and forex shortage, liberalization of the banking sector given the country’s forex reserves, , liberalizing the banking sector given the country’s economic performance, liberalization of the banking sector and its effect on FDI flow to Ethiopia, liberalization of the banking sector and its effect on trade, liberalizing the banking sector given the country’s political performance, liberalizing the banking sector given the country’s regulatory capacity, liberalization of the banking sector and its implication on the future foreign currency flow the country, banks that are most likely to enter if the banking sector is liberalized, liberalization of the banking sector and policy framework of the country, liberalization of the banking sector and the proliferation of exporting economy and liberalizing the banking sector given the country’s potential have emerged as a theme. Finally, the results and findings were discussed.

Chapter Four

Data Analysis and Interpretation

4.1 Profile of the Respondents

Among the nine people interviewed three were economists from Ethiopian Economists Association; in which two of them are senior researchers and a junior researcher. Two of the respondents were economists at the National Bank of Ethiopia at the Monetary and Financial Analysis Directorate. Another respondent was a macro economy policy expert at the NPC. An economist from the MoFEC was also among the respondents. The other respondent was a private bank branch manager.

4.2 The Prohibition of Foreign Banks and Foreign Currency Shortage

An expert at Ecobank said that “when foreign banks are allowed to legally operate in Ethiopia’s banking industry, they would be required to have a paid up capital up to $300 million. The capital will be deposited in NBE. If the number of foreign banks entering the banking sector increases, the country’s central bank will have a large amount of foreign currency. This would improve the foreign currency shortages of the country for some time.”

“Foreign banks would bring capital if Ethiopia’s banking industry is liberalized” said the branch manager at Awash bank. He also added that “their investment would improve the recent foreign currency shortages”. On the other hand, the manager questions the sustainability of the banks contribution in improving the forex shortages in the country. “Let’s say the banks inject liquidity for one year and supply importers the foreign currency they need but how about for the next year? I don’t think they will keep bringing foreign currency and provide it to those who need it for several years.”

An economist from MoFEC is skeptical about the whole idea that foreign banks would improve the country’s forex shortage. “I don’t think they would bring huge amount of foreign currency from their base country and provide liquidity to a level that can significantly reduce the country’s forex shortage”. Thus, according to him though the foreign banks could bring forex into the country but it will not be to a level that would solve the country's forex shortage es to a great extent.

Liberalizing the banking sector would improve the foreign currency shortages but it would be very difficult to say, it will solve the problem. It would be unrealistic to say the ever increasing demand for foreign currency will be addressed the participation of foreign banks following the liberalization of the banking sector.

4.3 Liberalizing the Banking Sector Given the Country's Forex Reserves

Ethiopia has one of the lowest foreign currency reserves. According to IMF (2018) International reserves at end-2016/17 stood at US$3.2 billion (1.8 months of prospective imports cover).

Most of the respondents agreed that Ethiopia's economy has the potential to generate forex. Foreign investors would value the potential of the economy to generate foreign currency i.e. competitiveness rather than the current foreign currency levels. Despite a declining foreign currency reserves (on the number of month it can cover import for) foreign banks would inject capital in the form of foreign currency in Ethiopia's economy if the policy changes. Although foreign currency reserves indicates a country's export performance, global competitiveness and the health of its economy, having low reserves will not affect foreign banks' decision to invest to a great extent.

As an Economist from EEA argued "foreign banks want a long term presence in Africa. They will be willing to invest in Ethiopia knowing the risks". As a result, if Ethiopia's banking sector is liberalized, foreign banks will be keen to enter and invest. This would bring foreign currency into the country. A World Bank economist said foreign banks would evaluate the host country's economy and the market to generate profit. "They will consider if the market is untapped so that they understand the opportunities it can offer".

The expert at Ecobank said "though Ethiopia has low forex reserves foreign banks are willing to enter. Many foreign banks are still waiting to enter. That's why banks from Africa and Europe such as Commerz and Deutsche bank have opened representative offices in the country".

The outcomes of the negotiation are very important. EEA economist said "at a time of liquidation foreign banks would want the NBE to exchange all of the local currency in their control with foreign currencies. It is difficult to say the government would agree to conditions like this given the country's foreign currency reserve". However, the economist from World Bank said "foreign banks would manage their own foreign currency. The country's forex reserve will not affect their commitment to inject foreign currency to a great extent. Whenever they want to liquidate they can sell their assets.

Ethiopia's economy is an emerging economy and growing. Despite NBE's policy which require the banks to put 27% of their total loans in to purchasing bonds of the Grand Ethiopian Renaissance Dam; the country's banks are profitable. If the banking sector is liberalized, foreign banks would be willing to inject liquidity in foreign currency as they would want to reap the benefit by entering the country's banking sector. This in turn would increase the inflow of the foreign currency of the country. However, to ensure the stability of the banking sector and the economy as a whole, the country must increase its forex reserves. As the banking sector expands and foreign banks enter, so does the scale of the damage to the economy in case of an economic recession on other volatile conditions across the globe. Hence, before liberalizing the banking sector, holding more forex reserves is very important to mitigate the risks.

4.4 Liberalizing the Banking Sector Given the Country's Economic Condition

GDP is the aggregate of personal consumption expenditures; business investment, government spending and net export i.e. export minus imports (thebalance.com, 2018). Economic growth in GDP terms shows the direction in which an economy is heading. A growing economy indicates the presence of investment by the government and the private sector.

To keep the growth momentum; the availability of finance is key and the banking sector is the one that can supply businesses with finance. To sustain a growing economy a robust banking sector that parallels with the pace of the economy is important.

According to the IMF (2018) Ethiopia is the fastest growing economy in Africa with 8.5% annual growth rate. Currently, though Ethiopia's economy is growing; finance is a challenge. Ethiopia is not a country which produces most of the goods it consumes. Thus it relies on imports; which requires foreign currency. The fast growing economy needs a huge amount of foreign currency and the local banks don't have the capacity to provide the forex as needed.

Most of the respondents agree allowing foreign banks to operate would enable to bring in more foreign currency into the economy and help bridge the widening gap between imports and exports. But it has its own risk as well. An expert from Ecobank said “looking at Ethiopia’s economy, it is an attractive market but there are challenges as well. Many western banks are reducing their operations because they believe the risks are high”, he added. Thus, allowing foreign banks to legally operate in the country might not bring an influx of foreign currency to the country since international banks weigh the country’s economic condition beyond GDP growth.

4.5 Liberalization of the Banking Sector and Its Effect on FDI Flow to Ethiopia

One advantage of having international banks in a country with almost all banks are operating locally is that international banks have advanced technologies, skilled man power, international experience and the financial capacity to render quality services to investors.

According to an economist from NBE “Multinational Corporations value the efficiency of the host country’s banking sector to a great extent”. He further added that Ethiopian banks are not in a position to provide foreign companies the services they would get in places where international banks operate In recent years Ethiopia has been attracting an increasing number of foreign companies.

In 2016/17 foreign direct investment (FDI) growth, was 27.6 percent due to investments in the new industrial parks and privatization inflows (IMF, 2018). However, liberalizing the banking sector would increase the FDI flow even more. Foreign companies especially multinationals operating in many parts of the world would invest in the country even more if the banking sector is open for international banks. Consequently, more foreign currency would flow into Ethiopia’s economy.

4.6 Liberalization of the Banking Sector and Its Effect on Trade

The expert from Ecobank believes that liberalization of Ethiopia’s banking sector will encourage trade. He said “recently there are signs of reforms in areas like telecom which foreign firms’ entry has been prohibited. If the government push for reforms and liberalize the country’s banking sector, trade will be facilitated. Ethiopia wants to be a member of the WTO and one of the conditions set by the WTO is liberalization. If Ethiopia liberalizes its banking sector and become a member of WTO, it will be able to trade with many countries freely. This will allow the country to export more products. Currently Ethiopia's main export destinations are countries outside Africa. Trade with its East African neighbors is low. Trade among East African WTO member countries such as Kenya, Rwanda and Uganda is high. The WTO membership will increase the trade between Ethiopia and its East African neighboring countries".

The respondents agreed that due to their diversified operations and international presence foreign banks hold more foreign currency than the local banks. "Since they have deposits in foreign currency, foreign banks would most likely finance trade." a World Bank and EEA economists. The World Bank economist added that "foreign banks will capitalize on their advantage of foreign currency and attract more importers". Hence, importers don't have to wait long time for securing foreign currency to import goods if the local banks are in short of foreign currency.

Furthermore, economists from NBE and EEA said "unlike Ethiopian banks foreign banks can lend not only in the local currency but also in foreign currencies". Businesses that need to borrow in order to import goods; raw materials etc. can directly take the foreign currency rather than taking the loan in birr and waiting to convert that to foreign currencies. Hence, manufacturing firms will not to operate under capacity because of foreign currency shortage.

The availability of foreign currency also helps the manufacturing sector. Ethiopian manufacturers rely on imports for inputs used in the production process. Especially, most chemicals used in a number of industries are imported.

According to Abreha (2014) most manufacturing firms source production inputs from the world market. This feature shows that there is heavy reliance on imported intermediates and capital goods, partly due to limited availability of domestically manufactured inputs.

Manufacturers would quickly import machinery, raw materials or other items necessary for producing goods and don't necessarily have to halt production until they obtain the foreign currency they requested . Thus, it enables the country's manufacturing sector to be efficient and competitive.

Although Ethiopia is a country that exports mostly primary goods i.e. agricultural products such as coffee, oil seeds, vegetables and livestock, it also export secondary products like electrical machines, equipment, textiles and foot wear. The contribution of the latter to the total export is low. Ethiopia's ability to export such products would grow if the manufacturing industry secures foreign currency quickly.

Liberalizing the banking sector would facilitate trade which in turn helps to attract more foreign currency to flow into the country's economy. This would help the country's export to thrive and more foreign currency would be earned as a result of a strong performing export sector.

4.7 Liberalizing the Banking Sector Given the Country's Regulatory Regime

Regulation is very essential as it is used as a tool by governments to maintain the stability of their countries' economy. In some countries the government's role is limited. NBE economist said "in countries such as South Africa the government does not directly control the central bank". Foreign companies prefer countries with loose regulation as it provides the companies with opportunities to earn more profits, he added.

The branch manager at Awash bank said "if Ethiopia's government decides to liberalize the banking sector, the directives issued by the NBE would change." An economist from NBE said "in areas such as profit repatriation some of the rules which are currently in place for FDI investors might be applied if Ethiopia allows foreign banks to legally operate in its banking sector".

However, due to the sophistication of their operations regulating foreign banks can be difficult, the economists agreed. A macroeconomic policy expert from NPC said "even though foreign banks are forbidden from operating still there is a gap in regulating the local banks. The central bank lacks the man power and technology to regulate international banks". Taking into account the current the regulatory capacity of NBE; the central bank will struggle to keep up with foreign banks and regulate their activities.

If foreign banks are permitted, there could be outflows of foreign currency in many ways as the government cannot effectively regulate their activities. This has been the main argument by Ethiopia's government for not opening the country's banking sector to foreigners. Thus, liberalizing the banking sector at this point would paves the way for even more foreign currency out flows and result in devastating consequences for the economy as well. Therefore, liberalization would do more harm than good to the country.

4.8 Liberalization of the Banking Sector and the Policy Framework of the Country

An economist from EEA said “foreign banks would want the government pursue free market policies”. Currently, the government has set many policies for the long term benefit of the country’s economy even if it is negatively affecting some industries.

Given some of the policies that are in place today, foreign banks might hesitate to invest in the country. For instance, Ethiopian banks are expected to buy bonds 27% of the loans they provided. An economist from NBE said all the local banks are forced to the condition. However, the government might not be able to force the foreign banks and impose such policies as it did to the local banks. Foreign banks could even go to court if the government imposes such policies. Therefore, the local banks would face difficulties to compete with the foreign banks since the policy is already enacted. This would force the government to consider policies like this one.

The expert at Ecobank proves the above point. “Some time ago Ethiopia’s government wants foreign banks to participate in lease financing” said the expert at Ecobank. “The government also wants the banks to purchase bond equivalent to 30% of the loan they provided and the banks disagree to the condition”. “I think the idea was that the government believes banks should contribute to the overall development of the country. Ethiopian banks have national interest. But what’s in it for foreign banks?”

The other policy which is going to affect banks is the one which orders banks to give up 30% of the foreign currency they earned to the government. A central bank’s policy this is not common in many countries. Foreign banks will resist policies such as this, said NBE’s economist. It is formulated recently and since it is a policy that makes the government’s big role in the country’s economy even bigger, foreign banks wouldn’t accept it. This might indicate that the government doesn’t want to open the country’s banking sector in a short period of time.

Before entering the Ethiopian market; foreign banks will have series of negotiations with the government said economists from the EEA and NPC. In the mean time the banks will do their due diligence.

The government would want the banks to lend foreign currency to sectors like manufacturing and export which are among areas given priority. “The banks’ primary motive is profit, just like the local banks” said the macroeconomic policy expert from NPC. He further added that “compared to other sectors like construction, manufacturing requires a lot of effort and it will take longer to repay debts. However, the sector can earn foreign currency in the long run.

Foreign banks would want to finance areas such as import and construction instead of manufacturing.” As a result, the willingness of the banks to dedicate their foreign currency to sectors like manufacturing will be questionable. Nevertheless, the entrance of foreign banks would benefit the export and manufacturing sector as the areas would get foreign currency. This would improve the foreign currency flow in the economy.

As most of the respondents agreed profit repatriation policy will also be a major factor that the banks will closely look at whenever they want to enter into a country. Due to the shortage of foreign currency the government wants some of the foreign currency to remain in the country. The banks would want the freedom to move their money as they like. Therefore, so as to persuade the banks to invest in the country both the parties should reach to a common ground. If the proposed policy by the government is regarded as too much, the banks may not be willing to invest heavily.

The respondents agreed that all of the local banks except CBE will face difficulties to compete with the international banks. Foreign banks that agree with the new policies set by the government would start operation and those that are not satisfied by the policies may avoid entering Ethiopia’s banking sector. The new policies will be in line with the global banking industry. An EEA economist said “global banking has its own rules and regulations. Thus, most of the policies currently in place will change. The policies would go along with the global financial system”. When the policy framework is suitable i.e. preferable for foreign banks to operate, it will encourage investment by the banks which helps to improve the foreign currency in circulation.

4.9 Liberalizing the Banking Sector Given the Country's Political Performance

One key criterion for a host country to lure investors is political stability. Investors always take into consideration the country's ability to maintain peace and order. It is when investors feel that their investment is safe that they become willing to invest. In the last three years, Ethiopia witnessed unrest in different areas. Properties of local as well as foreign investors were damaged and destroyed. The government has tried to control the situation. It also reimbursed investors whose properties were vandalized. Afterwards, the government made changes at the top level and restored peace. Even though the country is peaceful now, what happened on the last three years may drive away potential investors.

The unrest has caused significant damage to the country's economy. It is not only because of the destruction of properties and the strikes but also it resulted in a huge decline in FDI. Citing fdi intelligence website fdiintelligence.com, Ernst and Young (2017) Ethiopia, where FDI levels echoed impressive GDP growth in previous years, saw its FDI projects almost halve in 2016 (see annex 3), owing to political instability and drought. The country has also become less attractive for foreign investors as compared to previous year according to the firm's attractiveness index which evaluates the attractiveness of a country based on six pillars namely, macroeconomic resilience, market size, business enablement, Investment in infrastructure and logistics, economic diversification and governance and human development (see annex 4).

Acknowledging the fact that, years of unrest has affected investment and caused a serious damage to the economy in general, the respondents are confident about the future of the country's economy. Despite the recent political problems foreign banks will still be eager to enter Ethiopia's banking sector, the respondents said. According to Ethiopian Investment Commission report, Ethiopia has attracted $2.2 billion in FDI in the first ix months of the current Ethiopian Fiscal year 2017/18. The report further added that the manufacturing sector is among the sectors that has attracted the most investments. During the crisis the manufacturing sector has suffered as many factories became a target. Manufacturing requires commitment. Any investor that invests in the sector aims long term vision. The FDI flow shows foreign investors' confidence in Ethiopia despite the recent political turmoil.

As per the expert at Ecobank “Pan African banks such as ours wouldn’t close their branches whenever there is turmoil in the country we are operating. When West African countries were hit by the Ebola outbreak, Ecobank continued to operate. In South Sudan when the political crisis began many foreign banks closed their branches and left but we are still operating there” he added.

If the government changes its policy and permit foreign banks to legally operate in Ethiopia, foreign banks especially Pan African banks would invest and their investment would improve the foreign currency circulation in the economy.

4.10 Liberalizing the Banking Sector Given the Country’s Potential

Ethiopia is a country that has tremendous potential for growth. As one NBE economist said “we have a population of more than 100 million, which is a big advantage for growth.” According to the CIA World Factbook, 20.11% of the population is between 15to 24 and 29.58% is between 25 and 54. Hence, there are a large number of workforces which can bring a great opportunity to the development of the economy. Unlocking that will bring huge benefits for the banks. Thus, if the Ethiopian banking sector is opened up for foreigners, they will invest and their investment would improve the foreign currency flow.

Infrastructure is very important as it decisive for attracting investment. Having a good infrastructure would enhance productivity and facilitates trade. Ethiopia is now building massive infrastructure projects. Among the projects power generating dams are significant for the long term growth of the country. When the dams begin to generate powers, more investors would come and invest in various sectors. As a result, export would be boosted. If Ethiopia changes its policy and allow foreign banks, the banks would be willing to enter and work with both local and international companies operating in Ethiopia.

Wages around the world are going up. In countries like China labor is not as cheap as it used to be. According to Plekhanov (2017) citing the data from Euromonitor International, hourly manufacturing wages in China in 2016 exceeded those in every major Latin American economy except Chile and were around 70% of the level in weaker Eurozone countries such as Portugal.

According to Hauge and Irfan (2016) Ethiopia's manufacturing sector as a share of GDP remains 5%, well below the African average of 10%. Despite this, it is not a long-shot to predict that Ethiopia will catch up with countries like China and Vietnam in some low-tech manufacturing industries in the near future. These are industries for which labor costs are very important and right now you'd be hard pressed to find a country in the world that has cheap labor than Ethiopia.

Along with the construction of infrastructures and industrial parks, manufacturers around the world would be keen to invest. Development Bank of Ethiopia is the main bank that lends to investors investing in areas like manufacturing and export which have been given priority by the government. Due to this opportunity foreign banks would be willing to enter Ethiopia's banking sector if they are allowed. Taking into account the country's potential, foreign banks would like to invest. Thus, there will be capital inflow. As there is more investment, it will reduce the forex shortage in the country.

4.11 Liberalization of the Banking Sector and Its Implication on the Future Foreign Currency Flow the Country

If foreign banks are allowed to operate; they would try to control the market. To do so, they have to attract customers of local banks. Economists from the World Bank and EEA agreed that since foreign banks have deposits in foreign currencies, they would inject liquidity in foreign currency. Looking at the country's growing imports (see annex 1) importers would be delighted as it becomes easy to secure foreign currency. Hence, it encourages imports. Local banks will follow through in order to stay competitive in the market.

The expert from Ecobank said "many international institutions operating in Ethiopia including the EU, UN don't deposit their money in the country's banks. This is because it is difficult to get the foreign currency at any time as needed as a result of the foreign currency shortage. If the banking sector is liberalized and foreign banks are allowed, more foreign currency would be circulating since these institutions don't need to take their money abroad".

An economist from EEA argued that debt repayment is also a major factor that can affect the future foreign currency flow in the economy. He explained that foreign banks can finance projects by lending to investors. The debtor could ask some percentage of the loan to be in foreign currency. The banks may condition all the debt to be paid on foreign currencies when maturity due. It is with foreign currencies that most transaction across the world is carried out and the banks want their profits to be in foreign currency. Arrangements like this would propel more foreign currency to leave the country.

“Ethiopian government forbids local companies taking loan from foreign banks while they are operating in Ethiopia. As far as I know only MIDROC Ethiopia borrowed from African Development Bank.” The economist explained the government’s argument for this is if local companies are allowed to borrow from foreign banks, they could borrow even if the interest is high. When the maturity period for the loan dues, the companies will pay the interest and the principal which can be a lot as the interest is compounded. “Local companies cannot also take goods that are worth a lot of money on credit from foreign companies since in the future the payment will be on foreign currency”, he added. As a result, local companies are missing opportunities that could help them become competitive in global scale.

4.12 Liberalization of the Banking Sector and the Proliferation of Exporting Economy

According to the IMF (2018) recently Ethiopia overtakes Kenya as East Africa’s biggest economy. However, Ethiopian banking sector is relatively small. When it comes to the banking sector Kenya has more than 42 banks that are currently operating as compared to 18 banks in Ethiopia (see annex 2). A banks asset shows the financial strength of a bank. A bank with huge assets is capable of providing a large sum in loans to businesses. According to U.S. state department data (2015) CBE mobilized 65.1% of the total bank deposits and provided more than 50.4% of total bank loans in the fiscal year 2012/13.

In order to earn foreign currency and reduce the shortages sustainably, a country needs a strong export sector. To build an export oriented economy a country must have industries that are competitive in global scale. One advantage that can boost productivity is economies of scale. By producing in large quantity a company can reduce the unit cost. To achieve this, companies have to be large enough and that would require huge investments. In Ethiopia only the two government banks are capable of lending in a huge amount. Manufacturing in particular requires huge investment.

The inability of the local banks to provide loans in large amount forces the country to miss opportunities and face severe shortage of foreign currency. An economist from NBE said “it is too difficult for Ethiopia to found a bank with huge capital given the poverty level of our society". If foreign banks are allowed since they have the financial capacity they can provide liquidity to companies and that would improve the companies' capacity and enhance efficiency. Thus, they would be able to export more which would improve the foreign currency flow of the country.

4.13 Banks which are most likely to enter if the Banking Sector is liberalized

"Some of the foreign banks operating in many countries have expressed their intention to enter Ethiopia" said an economist from MoFEC. "South African, Kenyan, Turkish banks and a German bank wants to legally operate in Ethiopia" said EEA economist. There are foreign banks from different countries that have opened representative office in Ethiopia. The banks assist the companies which they have given credit.

An economist from NBE said "Africa's banking industry can be difficult for western banks as they are not get used to conditions that can negatively affect the industry such as rapid policy changes, political unrest or tight regulation but still western banks are operating in Africa". He further added that African banks including those who opened representative offices, Asian and Middle East banks could be more willing to invest. As the economy expands the country will need more banks. Therefore, if the policy changes; foreign banks would enter and provide liquidity in foreign currency in order to benefit from a fast growing economy.

EEA economist said that "Foreign banks can lend to companies based in their home country. The companies might have operations in other countries such as Ethiopia. Most of the time, the lenders follow the companies and support the businesses". In Ethiopia countries like China, Turkey and India are big investors. Hence, some of the banks in these countries would want to enter the Ethiopian banking sector to be available for the companies operating in Ethiopia. This doesn't mean that these banks only lend to companies of their country. Ethiopian businesses would also benefit from the entry of these banks. For instance, Ethiopian companies working with a Chinese firm could borrow in foreign currency from Chinese banks in Ethiopia. Liberalizing the banking sector would allow these banks to inject foreign currency into the economy.

The expert at Ecobank said that “since they are based in Africa and aim at interconnecting African countries through trade, Pan African banks would enter Ethiopia’s banking sector if the government liberalizes the sector”.

In any industry in order to succeed a company has to know the needs of customers it serves. The more it understands the preference of the consumers, the better chance it has to stay ahead of competitors. A World Bank economist said “local banks have better knowledge about the market since they have been operating for years”. This enables them to understand their customers need and the future trend in the sector. However, foreign banks have never been operational and know little about Ethiopia’s banking sector. To fill this gap, foreign banks could hire Ethiopian banking professionals who are experienced in the industry. If the banks get the permission to legally operate, the banks could enter through subsidiaries.

CHAPTER FIVE

Conclusions, Recommendations and Future Research Direction

5.1 Conclusions

Ethiopia's government has prohibited foreign banks from legally operating the country. The country faces severe foreign currency shortages and also has low forex reserves. Since foreign banks have deposits in foreign currency they would provide liquidity in terms of foreign currency. Allowing foreign banks would also increase the foreign exchange reserves of the country. However, the extent to which liberalization would improve the country's foreign currency shortages in the sustainable future is questionable.

Currently there are policies imposed by the country's central bank which are affecting the country's banks' profitability and liberalizing the banking sector would force the government to change some of the policies that are unfriendly to the sector.

Allowing foreign banks would reduce the government role in the banking sector. One is since the two state owned banks own the majority of the total banking asset, as foreign banks enter; their domination would decrease and their asset to total banking asset ratio would decline. Among other banks; Pan African banks such as Kenyan and South African banks would most likely enter remain committed and if Ethiopia's government changes its policy.

The policies which will be proposed by Ethiopia's government will be key in determining the level of investment by the foreign banks if the country liberalizes its banking sector.

Since Ethiopia faces forex shortages because of the imbalance between imports and exports among other causes, the banking industry alone cannot solve the problem. Foreign banks would increase the foreign currency inflow by enabling the country to attract more FDI and providing the country's manufacturing sector with foreign currency to acquire inputs such as raw materials timely so that they can export the finished products. However, the banks will only be providing services and inject foreign currency into the economy. The performance of Ethiopia's export sector is the key part in the country's forex shortages. To boost its export and earn more foreign currency the country has to produce products and services that are competitive in global scale.

Though foreign banks contribute to building a strong export sector, they cannot change the structure of the country's economy. Hence, liberalizing the banking sector would not solve the foreign currency shortages.

Liberalization of the banking sector also has its own pros and cons for the country's economy. The country's regulatory capacity is low. This will affect the country's economy if Ethiopia opens up its banking sector as it will result in more outflows and worsens the current foreign currency shortage. Given the country's regulatory capacity and economic level; liberalizing the banking sector would have negative repercussions to the economy which could bring economic shock and lead to more outflows of foreign currency.

5.2 Recommendations

Based on the findings of the study, the researcher forwards the following as recommendations:

Since liberalizing at this point would lead to more foreign currency outflow rather than inflow. Building a strong export sector is the most feasible option to reduce the shortages in the sustainable future. To do so, it requires the joint effort of both the government and the private sector. The country has to be competitive in global scale. Offering quality products at a competitive price will help the country boost its export earnings.

Due attention should also be given to strengthen Ethiopia's banking sector. Thus,

- The government should remove restrictions that are affecting the profitability of the banks.
- M & A is one way. Merger will allow banks with smaller asset to combine their resources and become competitive.

NBE should also improve the regulatory and supervision capacity to effectively monitor the activity of banks.

- Providing continuous training and development programs to staff about the global banking system would help the government to build its regulatory and supervision capacity.

- The central bank should also focus on monitoring whether or not the country's banks are allocating the foreign currency to sectors which the government decided to be given priority in terms of allocating foreign currency.

If the government decides to liberalize, it shouldn't be full liberalization. Using its policy as an instrument the government can make the banks contribute to the development of the economy while they are still making profits.

- Lengthening the time it takes for foreign banks to repatriate the profits.
- Directing the foreign banks to lend certain percentage to Ethiopian businesses from the total amount of foreign currency loan they provide. This will make the banks not to only lend the foreign companies that are operating in Ethiopia.

5.3 Future Research Direction

This research made analysis on how liberalization of Ethiopia's banking sector could affect the country's foreign currency flow by interviewing individuals from different institutions. However, the respondents don't include academicians from educational institutes, consultants, Ministry of Trade and banking supervision department at NBE. Thus, future researchers can incorporate the views of the individuals from the mentioned institutions and provide further analysis on the topic.

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Annex 1. Ethiopia's Macroeconomic Indicators

Indicators	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16
GDP at Current Market Price (In Mn. Birr)	67,351.0	65,895.0	72,703.0	85,800.0	105,415.0	130,334.0	170,281.0	245,836.0	332,060.0	379,135.00	515,078.50	747,326.50	866,921.08	,060,825.38	,297,961.44	,528,044.23
Real GDP Growth Rate (In %)	7.4	1.6	(2.1)	11.7	12.6	11.5	11.8	11.2	10.0	10.57	11.40	8.70	9.90	10.35	10.40	8.00
Exports	8,146.0	8,398.0	9,779.0	12,913.6	16,076.9	18,205.4	21,854.2	28,317.0	35,233.0	52,168.00	85,949.80	102,887.00	108,227.10	123,496.00	121,532.20	122,366.00
Imports	16,108.4	17,706.8	20,131.3	27,366.8	37,776.3	48,092.4	55,088.7	76,564.0	96,285.0	126,319.00	162,486.80	236,384.70	251,300.60	308,691.30	393,189.00	424,528.00
Number of Commercial Banks	8	8	8	9	9	10	11	11	12	14	17	17	18	18	18	18
Number of Bank Branches	283	295	339	358	389	421	487	562	636	681	970	1,289	1,724	2,208	2,693	3,187
Population : Bank Branch	217668:1	214237:1	191150:1	185754.2:1	175778.4:1	166,270.8:1	148,665.3:1	133,274:1	120,754.7:1	115,712.2:1	83,195.9:1	64,158.3:1	49674.8:1	41,088	33,448.00	28,932.00

Source: National Bank of Ethiopia Annual Report 2015/16

Annex 2. Banks in Ethiopia and Kenya

List of banks in Ethiopia

Banks	Total assets (Amount in Millions of Birr) As to June , 2014
Commercial Bank of Ethiopia	485,700(as of 2017)
Awash International Bank	22,106.35
Bank of Abyssinia	11,276.39
Dashen Bank	21,962.20
Development Bank of Ethiopia	N/A
Nib International Bank	10,747.28
United Bank	11,876.36
Wegagen Bank	11,528.70
Cooperative Bank of Oromia	7,350.37
Lion International Bank	3,613.33
Oromia International Bank	6,151.66
Zemen Bank	3,924.76
Berhan International Bank	3,011.94
Bunna International Bank	2,841.26
Abay Bank	3,196.78
Addis International Bank	1,262.72
Debub Global Bank	874.2
Enat Bank	1,417.34
Total	123,142.26 (excluding CBE)

Source: National Bank of Ethiopia

List of Licensed Commercial Banks in Kenya as at March 31, 2017

1. African Banking Corporation Ltd Bank Ltd
2. Bank of Africa Kenya Ltd.
3. Bank of Baroda
4. Bank of India
5. Barclays Bank of Kenya Limited
6. Charterhouse Bank Limited
7. Chase Bank (K) Ltd
8. Citibank N.A Kenya
9. Commercial Bank of Africa Ltd
10. Consolidated Bank of Kenya Ltd
11. Co-operative Bank of Kenya Ltd.
12. Credit Bank Ltd.
13. Development Bank of Kenya Ltd
14. Diamond Trust Bank (K) Ltd.
15. DIB Bank (Kenya) Limited
16. Ecobank Kenya Ltd.
17. Spire Bank Ltd.
18. Equity Bank Ltd
19. Family Bank Ltd.
20. Fidelity Commercial Bank Limited
21. First Community Bank Limited.
22. Guaranty Trust Bank (Kenya) Ltd
23. Guardian Bank Ltd.
24. Gulf African Bank Limited.
25. Habib Bank A.G Zurich
26. Habib Bank Ltd.
27. I & M Bank Ltd.
28. Imperial Bank Limited
29. Jamii Bora Bank Ltd.
30. KCB Bank Kenya Ltd.
31. M Oriental Bank Ltd.
32. Middle East Bank (K) Ltd.
33. National Bank of Kenya Ltd.
34. NIC Bank Ltd.
35. Paramount Bank Ltd.
36. Prime Bank Ltd.
37. Sidian Bank Limited
38. Stanbic Bank Kenya Limited
39. Standard Chartered Bank (K) Ltd.
40. Trans-National Bank Ltd.
41. UBA Kenya Bank Limited
42. Victoria Commercial Bank Ltd.

Total Asset (as of 2016) SH 4.1 trillion

Source: Central Bank of Kenya

Annex 3. FDI projects in 15 African Countries

Number of FDI projects

Rank	Country	2016	2015	Percentage change
1	South Africa	139	130	6.9
2	Morocco	81	74	9.5
3	Egypt	79	66	19.7
4	Nigeria	51	53	-3.8
5	Kenya	40	95	-57.9
6	Cote d'ivoire	34	28	21.4
7	Ghana	28	41	-31.7
8	Tanzania	22	23	-4.3
9	Tunisia	18	13	38.5
10	Algeria	17	13	30.8
11	Ethiopia	16	30	-46.7
12	Mozambique	15	32	-53.1
13	Zambia	13	13	0.0
14	Rwanda	11	13	-15.4
15	Senegal	10	10	0.0

Source: fDi Markets (as cited by EY)

Annex 4. The ranking of the top 25 countries on AAI 2017, both on overall basis as well as on each of the six pillars

Country	Overall			Macro-economic resilience	Market size	Business enablement	Investment in infrastructure and logistics	Economic diversification	Governance and human development
	Rank of 2017	Rank of 2016	Change in Ranking						
Morocco	1	2	1	18	9	3	4	5	8
Kenya	2	4	2	2	8	10	16	10	16
South Africa	3	1	-1	33	5	6	1	2	6
Ghana	4	6	2	17	11	8	7	14	7
Tanzania	5	12	7	1	4	18	18	23	16
Uganda	6	13	7	4	10	11	24	8	23
Cote d'Ivoire	7	9	2	3	13	16	11	18	22
Mauritius	8	5	-3	20	39	1	8	1	1
Senegal	9	11	2	12	16	23	17	4	12
Botswana	10	7	-3	9	31	2	5	32	2
Egypt	11	3	-8	42	3	15	2	7	13
Rwanda	12	9	-3	8	32	4	22	15	9
Tunisia	13	8	-5	38	22	14	6	3	4
Namibia	14	18	4	22	32	5	10	25	4
Algeria	15	16	1	28	6	36	3	28	11
Zambia	16	17	1	24	15	7	31	26	10
Nigeria	17	15	-2	16	1	33	14	33	24
Cape Verde	18	23	5	30	42	13	13	10	3
Cameroon	19	22	3	11	14	35	23	21	31
Ethiopia	20	14	-6	10	12	38	36	16	26
Burkina Faso	21	21	0	7	22	22	29	35	21
Mozambique	22	20	-2	39	18	17	19	9	31
Madagascar	23	24	1	15	21	30	42	13	30
Mali	24	28	4	25	19	20	27	37	25
Benin	25	19	-6	21	28	21	33	31	18

Source: Ernst and Young, AAI 2017 country ranking

Annex 5

Interview Guide

1. Do you think foreign banks will inject liquidity given the country's foreign exchange reserves if the banking sector is liberalized?
2. Given Ethiopia's economy, do you think foreign banks will inject liquidity to a level that can improve the country's forex flow if the banking sector is liberalized?
3. Do you think foreign banks will inject liquidity given the country's political situation if the banking sector is liberalized?
4. Given the country's regulatory framework, do you think foreign banks will inject liquidity to a level that can improve the country's forex flow if the banking sector is liberalized?
5. What do you think about liberalization of Ethiopia's banking sector given the regulatory capacity of NBE?
6. If Ethiopian government decides to liberalize the banking sector, how do you think it would be?
7. Do you think liberalization of the banking sector benefits the country? If yes how?
8. Do you think foreign banks will inject liquidity given the country's potential if the banking sector is liberalized?
9. If the Ethiopian government decides to liberalize the banking sector; banks from which countries will enter?
10. Which entry strategies do you think they will choose?

Appendix

የኢትዮጵያ ብሔራዊ ባንክ
NATIONAL BANK OF ETHIOPIA
ADDIS ABABA

Directives No. FXD /47 /2017
Directives for Amendment of External Loan
and Supplier's Credit Directives No. REL /05/2002

Whereas, the National Bank of Ethiopia is vested by its establishment proclamation no. 591/2008 and Investment Proclamation no. 679/2012 to regulate foreign exchange and having determined the procedures of registration to external loan is essentially set to be a criterion of regulating foreign exchange;

Whereas, an investor who acquires an external loan shall have also obliged to register such a loan with the National Bank of Ethiopia in accordance with the directives of the National Bank of Ethiopia;

Now, therefore, in accordance with Articles 20 and 27(2) of the National Bank of Ethiopia Establishment (as amended) proclamation No. 591/2008_and article 36(1 and 2) of Investment Proclamation no. 679/2012, these directives are hereby issued as follows:

Article 1
Short Title

These directives may be cited as "External Loan and Supplier's Credit Directives No./47/2017."

Article 2
Definition

In these Directives, unless the context requires otherwise:

2.1 "**All-in-cost ceiling**" means rate of interest, other fees and expenses in foreign currency excluding commitment fee and pre-payment fee.

2.2 "**Bank** "means a company licensed by the National Bank of Ethiopia to undertake banking business or a bank owned by the Government;

1

አድራሻ፡ ሱዳን ጎዳና ፖ.ሣ.ቁ. 5550/2048 ፋክስ ቁጥር 0115 51 45 88 ስልክ ቁጥር 0115 51 74 30 አ.አ
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E-mail: nbe.excd@ethionet.et Website. www.http://www.nbe.gov.et

2.3 **"Exporter"** A person that sells goods or services that generate foreign currency;

2.4 **"External loan"** means a loan acquired from an eligible recognized lender and approved and registered by the National Bank of Ethiopia;

2.5 **"Foreign capital"** means paid up capital obtained from foreign sources, and includes the re-invested profits and dividends of a foreign investor and registered by pertinent government body;

2.6 **"Foreign Investor** "means a foreigner or an enterprise wholly owned by foreign nationals, having invested foreign capital in Ethiopia or a foreigner or an Ethiopian incorporated enterprise owned by foreign nationals jointly investing with domestic investor, and includes an Ethiopian permanently residing abroad and preferring treatment as a foreign investor;

2.7 **"Guarantee** "means any signed undertaking, however named or described, providing for payment on presentation of a complying demand;

2.8 **"Investor"** means a domestic or a foreign investor having invested in Ethiopia;

2.9 **"Supplier's credit"** means an interim short term financing provided by a third party supplier;

2.10 **"Usance Letter of credit"** means a deferred payment letter of credit payable at a determined future date after presentation of conforming documents;

2.11 **"Person"** means any natural or juridical person;

Article 3
General

3.1 External loan guaranteed by Federal Government of Ethiopia shall be registered by the National Bank of Ethiopia by presenting the agreement and the guarantee issued there to.

3.2 An eligible borrower except stated under article 3.1 shall first get approval from the National Bank of Ethiopia before entering to external loan and supplier's credit agreement with the lender/supplier.

3.3 An eligible borrower shall register the foreign loan remitted in cash or in kind by producing the necessary documents.

3.4 No repayment in convertible foreign currency may be allowed for the purpose of payment of external loan or supplier's credit unless registered by the National Bank of Ethiopia.

3.5 A Bank is allowed to open usance letter of credit for an exporter who imports equipment, raw materials, machineries and accessories for his export business against future export proceed.

Article 4
Eligible Borrowers and Requirements

4.1 Exporter

4.1.1 An exporter is eligible to acquire an external loan or supplier's credit provided that the acquired loan is going to finance an export - oriented investment that generates foreign currency.

4.1.2 A domestic investor who is engaged in projects that generate foreign currency is eligible to acquire external loan.

4.1.3 The following requirements shall be fulfilled for approval and registration of external loan or supplier's credit to be acquired by an exporter:

a) Application letter;

b) Valid export license given by pertinent licensing authority;

c) For External loan; The draft loan agreement with detailed terms showing interest rates and applicable charges, loan disbursement schedule, repayment schedule, borrower-lender relationship, purpose of the loan and other particulars as may be deemed necessary by the National Bank of Ethiopia

d) For suppliers credit; Pro-forma invoice with repayment period and term of payment

e) Document justifying the capacity to repay the loan

4.2 Foreign Investor

4.2.1 A foreign investor is eligible to acquire external loan when it fulfills all requirements of article 4.2.3 of these directives

4.2.2 the debt to equity ratio may not exceed 60:40 of the foreign capital

4.2.3 The following requirements shall be fulfilled for approval of external loan and/or supplier's credit to be acquired by foreign investor:

- **a)** Application letter;
- **b)** Valid investment or any other valid business license given by pertinent licensing authority as the case may be applicable;
- **c)** Foreign capital registration certificate issued by pertinent government body
- **d)** For external loan; the draft loan agreement with detailed terms showing interest rates and applicable charges, loan disbursement schedule. repayment schedule, borrower-lender relationship, purpose of the loan and other particulars as may be deemed necessary by the National Bank of Ethiopia;
- **e)** For suppliers credit; Pro-forma invoice with repayment period and term

Article 5

Approval and Registration of External Loan

5.1. The National Bank of Ethiopia shall issue approval letter for external loan and suppliers credit if all conditions are fulfilled under article 4.1 and 4.2

5.2. The National Bank of Ethiopia shall register external loan up on presentation of the following documents:

- **a)** Application letter;
- **b)** A bank advise (if the loan is in cash);
- **c)** Customs declaration and all relevant shipping documents (if the loan is in kind);
- **d)** Copy of external loan approval letters

Article 6

All- in- Cost Ceilings

6.1. The all-in-cost ceilings for external loan shall be:

Average Maturity Period	All-in-cost Ceilings
Up to three years	six month LIBOR or Equivalent in EURIBOR Plus 2%
Three years and up to five years	six month LIBOR or Equivalent in EURIBOR Plus 3%
More than five years	six month LIBOR or Equivalent in EURIBOR Plus 5%

6.2. When a changing international market requires, the National Bank of Ethiopia may vary the all in cost ceiling stated here in above.

Article 7

Guarantees

Any form of guarantee may not be issued by government and banks for private loan.

Article 8

Repayment of External Loan

8.1. The National Bank of Ethiopia shall approve repayment of external loan provided that the repayment request is as per the conditions mentioned in article 5 of these Directives.

8.2. The following documents should be presented to the National Bank of Ethiopia for approval of an external loan repayment:

- **a)** Application letter;
- **b)** Copy of external loan registration letter and
- **c)** Loan repayment schedule showing the computation of principal, interest and other charges as may deemed necessary by the National Bank of Ethiopia.

Article 9

Repeal

Registration of External Loan and suppliers' or Foreign Partners' Credit Directives No REL/005/2002 is hereby repealed and replaced by these Directives.

Article 10

Effective Date

These Directives shall enter into force as of October 03, 2017.

TEKLEWOLD ATNAFU
GOVERNOR