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Literature Review

Opening the Ethiopian Banking Sector to Foreign Investors: Advantages and Disadvantages (A Literature Review)

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ABSTRACT: *For decades, the Ethiopian banking sector has remained closed to foreign investors. The government's main rationale for restricting foreign participation was the concern that international banks being more financially robust, technologically advanced, and reputable would overshadow and weaken the growth of Ethiopia's nascent and underdeveloped domestic banking industry. Recently, however, the government has enacted a new law permitting the entry of foreign banks into the country. This review examines the potential advantages and disadvantages of this policy shift. The anticipated benefits include the introduction of new financial innovations and technologies, increased foreign direct investment, accelerated economic growth, enhanced availability of foreign exchange, and greater facilitation of international trade. Moreover, foreign bank entry is expected to help alleviate Ethiopia's persistent foreign exchange shortages. Nonetheless, significant risks exist if the reform is not carefully regulated. Without strong oversight by the National Bank of Ethiopia, the dominance of foreign banks may undermine local institutions and expose them to heightened vulnerabilities. The article concludes that while opening the banking sector presents important opportunities for Ethiopia's economy, careful implementation and stringent regulatory frameworks are critical to safeguarding domestic banks and ensuring balanced, sustainable financial sector development.*

KEYWORDS: *Ethiopia, Banking Sector, Foreign Investors, Liberalization, Advantages and Disadvantages.*

1. INTRODUCTION

In recent years, the Ethiopian government has taken significant steps to liberalize the banking industry. One notable development was the introduction of interest-free or Islamic banking services, which had previously been unavailable in the country. The entry of Islamic banking marked a major shift, as it is based on religious principles that prohibit interest payments (Tesfaye, 2024). Banks operating in this segment must comply with specific regulatory guidelines, thereby introducing new financial services into the market. This move is widely regarded as a milestone in Ethiopia's gradual transition towards liberalization and free-market principles (Kabir & Hossain, 2021).

Another historic development was the enactment of a new banking proclamation (No. 1360/2017), which opened Ethiopia's financial sector to foreign investors after decades of restrictive policies that had excluded foreign banks. The policy change was motivated by the country's urgent need for foreign capital, resources, and expertise. By allowing foreign banks to operate, the government aims to enhance competition, reduce foreign exchange shortages, attract foreign direct investment, promote financial technology transfer, expand financial inclusion, and strengthen the competitiveness of the sector. Ethiopia, Africa's second most populous nation with over 100 million people, has only 28 banks, and just 20% of its population holds a bank account, according to World Bank data (Alemayehu, 2024). The entry of foreign banks is therefore expected to unleash the financial market's potential and foster deeper integration with the global economy.

Like many other developing countries, Ethiopia had long delayed liberalizing its financial sector, unlike some of its East African peers such as Kenya, Tanzania, and Uganda (Fetene, Birku, Shibiru & Abule, 2022). The debate on financial liberalization has produced two contrasting perspectives among scholars. On one hand, McKinnon (1973) and Shaw (1973) argue that excessive government intervention distorts financial markets, discourages savings, and leads to inefficient investments. On the other hand, critics warn that if poorly managed, financial liberalization can destabilize the financial system and trigger crises (Stiglitz, 2000; Yin, 2019).

Despite Ethiopia's reform efforts, state-owned banks continue to dominate the market, limiting competition and private sector participation. Nevertheless, liberalization has enabled banks to experiment with new technologies and services. The restructuring of state-owned banks to align more closely with market principles has also marked an important transformation.

By reducing dependence on state ownership, these reforms have opened space for broader participation in the financial ecosystem, allowing diverse actors to contribute to the sector's growth and modernization (Tesfaye, 2024).

2. ISSUES RELATED TO LIBERALIZING THE FINANCIAL SECTOR IN ETHIOPIA

A key question that arises in the context of financial sector liberalization is: to what extent are Ethiopian financial institutions competitive? Evidence suggests that Ethiopia's financial sector remains relatively weak and underdeveloped when compared to that of other Sub-Saharan African countries that have already opened their financial markets to foreign investors. The findings indicate that Ethiopian banks lag behind in terms of efficiency, innovation, and competitiveness, highlighting structural challenges that may hinder the sector's ability to fully benefit from liberalization.

2.1. DOMESTIC OPERATORS' PERCEPTIONS OF THE FINANCIAL SYSTEM IN ETHIOPIA

Studies indicate that most financial sector actors perceive Ethiopia's financial system as generally inefficient and weak. It is characterized by limited institutional capacity, both in terms of technology and expertise, alongside poor strategic leadership. The sector is described as non-competitive, unstable, lacking innovation, diversity, and inclusiveness, and as having minimal influence in driving broader economic transformation (Fetene, Birku, Abule & Shibiru, 2022).

The range of financial products offered by Ethiopian institutions is largely restricted to basic services, with little adoption of modern innovations such as e-commerce, e-marketing, biometric identification, or remote data processing. Several factors contribute to these limitations, including low levels of financial inclusion, weak innovation, and a lack of product diversification. Additional structural challenges include Ethiopia's dispersed rural population, inadequate infrastructure (roads, electricity, and internet access), widespread poverty, persistent inflation, and insecurity in remote areas. Other critical issues highlighted by stakeholders include low national savings rates, reliance on collateral-based lending practices, and inconsistent directives from regulatory authorities. Moreover, the sector is heavily constrained by stringent regulations imposed by the National Bank of Ethiopia, coupled with low levels of financial literacy and limited public awareness of financial services.

Political interference also undermines the independence of the National Bank, reducing its effectiveness in supervising the sector. Strict regulatory oversight is necessary to maintain financial stability, particularly if foreign banks are granted entry. However, the lack of political autonomy and weak supervisory capacity present major barriers to effective monitoring and control of the financial industry.

2.2. PROSPECTIVE CONSEQUENCES OF FINANCIAL SECTOR LIBERALIZATION

Studies show that financial sector liberalization presents both opportunities and risks, with short-term and long-term implications. On the positive side, foreign investors can enhance efficiency and thereby contribute, both directly and indirectly, to economic growth. However, liberalization also carries risks, as the entry of foreign banks may increase financial instability, which in turn could negatively affect economic performance.

Based on survey conducted by Fetene, Birku, Shibiru, and Abule (2022), the potential positive effects of foreign banks entry on domestic financial institutions include: Introduction of new technology, innovation, and skills into the banking system (98%), Increased competition (90%), Expansion of financial markets (76%), Strengthening of financial infrastructure (92%), Improved access to credit (71%), Transfer of international best practices and institutional experience (74%), Improved consumer welfare and access to long-term credit, thereby benefiting the macroeconomy (83%), Acceleration of foreign direct investment (82%), Job creation and wage growth (78%) and Lower borrowing costs through reduced interest rates (63%).

At the same time, respondents also noted potential negative consequences of liberalization. According to Fetene, Birku, Shibiru, and Abule (2022), the presence of foreign banks could: Reduce the market share of domestic financial institutions (80%), Weaken the overall resilience of local financial institutions (66%), Trigger unexpected and volatile capital inflows (58%), Contribute to macroeconomic instability (35%) as well as disadvantage small domestic institutions through restricted access to credit and related challenges (25%).

In summary, while financial sector liberalization in Ethiopia could enhance competitiveness, innovation, and integration into the global economy, it also poses significant risks that require careful management to avoid undermining domestic financial stability.

2.3. ALTERNATIVE APPROACHES TO LIBERALIZATION AND LESSONS LEARNED

Studies on financial sector liberalization, supported by the experiences of other countries, suggest that before Ethiopia opens or liberalizes its secondary financial sector, certain prerequisites must be addressed. These include liberalizing capital accounts (e.g., foreign loans and multiple currency markets), ensuring macroeconomic stability, and strengthening the regulatory capacity of oversight institutions. Evidence shows that the entry of foreign banks into developing economies presents both benefits and challenges. In recent years, banking practices in developing countries have evolved significantly under the pressures of financial liberalization, growing exposure to global capital flows, and advances in technology and finance.

Competition from international banks often compels local banks to lower costs and expand service offerings. In response, domestic banks seek to improve the quality of their services, increase efficiency, and broaden access to financing. The entry of foreign banks, especially large multinational institutions, can therefore enhance overall sector efficiency, facilitate international capital flows, promote credit availability, and contribute to economic growth.

At the same time, foreign banks also pose potential risks. They may disrupt the domestic economy and undermine long-term growth, particularly if their operations prioritize larger and more established firms while neglecting small and medium-sized enterprises. Their superior performance gives them a competitive advantage, which can displace domestic banks, especially if careful preparatory research and protective measures are not in place. Local banks may become overburdened by competition, and in extreme cases, face the risk of collapse. Furthermore, foreign banks tend to withdraw quickly from host markets during times of economic crisis, which can destabilize the domestic financial system. Additional risks associated with foreign bank entry include financial sector dominance by international institutions, exposure to global economic fluctuations, reduced lending to smaller businesses, and heightened vulnerabilities such as foreign exchange shortages, capital flight, and increased remittance outflows. Losses incurred abroad by multinational banks may also spill over into host economies, creating additional instability (Alemayehu, 2024).

2.4. CONCEPTS OF FOREIGN BANKS' ENTRY AND EXPERIENCES OF SOME COUNTRIES

2.4.1. CONCEPTS OF FOREIGN BANKS' ENTRY (FBE)

Foreign banks play a significant role in promoting financial sector development for several key reasons:

- Access to Global Capital and Risk Diversification**:** Foreign banks are generally less vulnerable to domestic economic shocks because they have access to international capital markets. This enables them to withstand local financial risks better than domestic banks and reduces their susceptibility to adverse economic conditions in the host country.
- Improvement of Banking Practices**:** The entry of foreign banks often introduces advanced banking practices, particularly in risk management, corporate governance, and operational strategies. This helps create a more efficient, competitive, and well-managed domestic banking sector.
- Crisis Management and Competition**:** In cases of crises within government-controlled banks, foreign banks are less likely to rely on government bailouts, which encourage fiscal discipline. Moreover, their presence fosters competition, prompting domestic banks to reduce costs, improve service quality, and enhance overall profitability.
- Contribution to Legal, Regulatory, and Economic Development**:** Foreign banks often help strengthen the legal and regulatory frameworks governing domestic banking. By leveraging their global experience and proximity to international financial markets, they provide reliable sources of credit and promote private sector lending, thereby contributing to broader economic growth.

2.4.2. EXPERIENCES OF SOME COUNTRIES

To remain competitive against foreign banks, domestic banks often need to invest significantly in advanced technologies and process improvements. The experiences of several countries illustrate how foreign bank entry can reshape domestic banking landscapes.

- Turkey: The entry of foreign banks into Turkey's banking sector has had a notable impact on domestic banks. Despite the relatively small scale of foreign operations, their presence has intensified competition, leading to reduced profitability for domestic banks. This heightened competition has pressured local banks to enhance their efficiency and adopt better management practices. Interestingly, during the global financial crisis of 2007- 2009, foreign banks in Turkey were able to maintain lending activities, which helped stabilize the banking sector during that turbulent period (Polovina, N., & Peasnell, K., 2023).
- Colombia: In Colombia, the liberalization of the financial sector and the influx of foreign banks have increased competition, which has generally benefited consumers through better services and lower costs. However, this competition has also posed challenges for domestic banks, particularly in terms of profitability and loan quality. Some studies suggest that the increased competition may have led to higher risks and deterioration in loan quality among domestic banks (Barajas, A., Steiner, R., & Salazar, N., 2000).
- Kenya and East Africa: Kenyan banks have expanded into the broader East African region, primarily through the establishment of branches in countries like Uganda, Rwanda, and Tanzania. This regional expansion has been driven by the desire for superior returns and the need to escape intense competition in the Kenyan market. Kenyan banks, such as Equity Bank and KCB Group, have become significant players in the East African banking sector. Their expansion has contributed to increased competition in the region, leading to improved banking services and financial inclusion (Kodongo, O., & Natto, D., 2014).
- Uganda, Rwanda, and Tanzania: Foreign banks have established a strong presence in several East African countries, including Uganda, Rwanda, and Tanzania. In these countries, foreign-owned banks control more than half of the total banking assets, indicating a significant influence on the banking sector. This dominance has led to increased competition, which has generally benefited consumers through better services and lower costs. However, the concentration of banking assets in the hands of foreign banks raises concerns about the stability and resilience of the domestic banking sectors in these countries (Gaertner, M., & Sanya, S., 2012).

2.5. HISTORICAL ARGUMENTS IN ETHIOPIA AGAINST FOREIGN BANKS ENTRY (FBE)

Foreign investments have historically been excluded from Ethiopia's banking industry. According to Banking Proclamation No. 592/2008 (Article 9), only Ethiopian nationals are permitted to invest in this sector. The government's primary rationale for restricting foreign participation has been the concern that international banks being more financially robust, technologically advanced, and reputable than local banks could undermine the development of the domestic banking industry. Ethiopia's banking and financial sector is still nascent, underdeveloped, and lacks the experience to compete with well-established foreign institutions. Consequently, opening the banking sector to foreign investors requires stricter regulations compared to other service sectors, as the entry of foreign banks may give rise to various economic and institutional challenges. The following section outlines some of these potential issues.

2.5.1. THREAT TO THE SURVIVAL OF DOMESTIC BANKS

The entry of foreign banks poses a significant threat to the survival of domestic banks in Ethiopia. Intense competition from well-capitalized and technologically advanced international banks may compel local banks to incur high short-term costs, reduce profitability, and focus primarily on major productive sectors, potentially destabilizing domestic credit. Given the limited capital, expertise, and technological capacity of Ethiopian banks, they may struggle to withstand the competitive pressure, increasing their risk of bankruptcy. Such a scenario could trigger a banking crisis, with adverse spillover effects on other banks and the broader financial sector, thereby threatening the stability of Ethiopia's banking industry.

Ethiopia's banking sector remains relatively underdeveloped in terms of capital, assets, skilled personnel, and modern banking technologies. Competing with foreign banks, which possess extensive financial resources, experience, and reputational advantages, may rapidly increase costs and reduce profitability for local institutions. Without careful regulation and the implementation of protective measures, the entry of foreign banks could jeopardize the survival of indigenous banks. While foreign banks bring global expertise, they are not infallible, and losses incurred in other markets could also negatively affect Ethiopia's economy.

2.5.2. CAPITAL OUTFLOW

A key concern regarding the entry of foreign banks is the potential for capital outflow. Foreign banks serve as conduits for both inward and outward capital flows, and during periods of economic instability, they may withdraw their funds from the domestic market rather than supporting the local economy. Such outflows can lead to a scarcity of deposits and foreign exchange, reducing the overall credit stability of domestic banks. In times of domestic crises, the rapid removal of capital by foreign banks could exacerbate financial instability and weaken the resilience of Ethiopia's banking sector.

2.5.3. LIMITED SUPERVISORY CAPACITY

The presence of foreign banks increases the complexity of regulatory oversight. Ethiopia may face high costs due to the limited capacity of its regulatory authorities, particularly the National Bank of Ethiopia (NBE), to supervise sophisticated international banks. Regulating foreign banks requires advanced expertise, cutting-edge technology, and robust institutional frameworks, which may currently be inadequate in Ethiopia.

Foreign banks' extensive capital, technological sophistication, skilled human resources, and global networks can make effective regulation challenging. They may introduce new methods and technologies that are difficult for local authorities to monitor or understand, potentially limiting government control over critical aspects of the financial system. Insufficient regulation and oversight could create opportunities for unethical practices, undermining the stability and integrity of the domestic financial sector. In the early stages of foreign bank entry, the NBE may face difficulties in formulating and enforcing effective policies, leaving the domestic banking system vulnerable.

2.5.4. MENACE OF INSTABILITY

Multinational banks may pose a risk to Ethiopia's financial system due to their operations in multiple countries. These banks often focus on large enterprises, manufacturing, and productive sectors, which can destabilize domestic credit availability. During periods of domestic instability, foreign banks may withdraw or relocate their funds, reducing the overall stability of lending by domestic banks. Their "cut-and-run" strategies can distort credit distribution in response to perceived risks or losses. A lack of clear and consistent information-sharing can further exacerbate instability. Effective regulation and strict limitations imposed by the National Bank of Ethiopia (NBE) are essential to mitigate these risks and ensure the safe entry of foreign banks into the domestic market.

2.5.5. SKEWING OF CREDIT AWAY FROM SMALL AND MEDIUM ENTERPRISES

The entry of foreign banks may lead to a bias in credit allocation, with small and medium-sized enterprises (SMEs) receiving limited financial support. Foreign banks typically prioritize large-scale investments, such as real estate and major corporate projects, and tend to operate in infrastructure-rich urban areas. Consequently, rural areas and smaller businesses where production often requires more labor-intensive efforts may be underserved. This bias can impede the growth of SMEs, which are crucial for inclusive economic development, and may exacerbate existing regional and sectoral disparities in access to finance.

2.6. CONCERNS REGARDING FOREIGN BANK ENTRY INTO ETHIOPIA'S BANKING SECTOR

Ethiopia's banking sector is widely recognized as lacking the capacity to compete with major international banks. Although recent proclamations permit the entry of foreign banks, challenges may arise if the National Bank of Ethiopia (NBE) does not enforce stringent regulations and operational limitations. Local banks could face heightened risks if foreign entry is allowed without careful implementation. Opening the banking sector to international competition carries inherent risks, similar to the constraints imposed on foreign investors previously affecting the growth of domestic banks. Until the sector gains sufficient experience and expertise, the presence of foreign banks may remain a source of concern. However, local banks can mitigate these risks through strategic measures such as mergers and operational collaborations. The law requires that domestic banks work closely with the NBE to develop competitive strategies to strengthen their position.

2.7. LEGAL BARRIERS TO FOREIGN BANK ENTRY INTO ETHIOPIA'S BANKING SECTOR

Historically, Ethiopian banking law restricted investment in the sector exclusively to Ethiopian nationals, effectively barring foreign banks from operating in the country. Article 9 of Banking Proclamation No. 592/2008 explicitly prohibited banks owned, wholly or partially, by foreign individuals or organizations from establishing branches or acquiring shares in Ethiopian banks. The regulation also prevented Ethiopian-born citizens living abroad from participating in the domestic banking sector, creating a highly restrictive legal framework prior to recent reforms.

The most recent amendment, under Banking Reform Proclamation No. 1159/2019, eased some of these restrictions. It allows foreign nationals of Ethiopian descent, as well as companies wholly or partially owned by such individuals, to invest in the banking sector. These entities must be registered under Ethiopian law, maintain their headquarters in Ethiopia, and conduct operations in approved foreign currencies. Despite this reform, foreign bank entry remains tightly regulated to ensure alignment with national financial stability and legal requirements.

2.8. ADVANTAGES OF FOREIGN BANK ENTRY INTO ETHIOPIA'S BANKING SECTOR

Ethiopia has begun to liberalize its banking sector, which has historically experienced slow growth due to restrictions on foreign participation. Allowing foreign banks to operate in Ethiopia can yield both advantages and disadvantages, as observed in other emerging economies. The liberalization of the banking sector has the potential to significantly benefit the national economy and foster the development of domestic banks. The following are some key advantages of foreign banks entering the Ethiopian financial system.

2.8.1. CREDIT AVAILABILITY

The participation of foreign banks can enhance the money supply and capital flows, increasing the availability of funds for domestic projects and potentially lowering interest rates, which stimulates economic growth. Financial liberalization is often used to expand access to financing in countries with underdeveloped financial systems, thereby strengthening the overall national financial infrastructure. In Ethiopia, the entry of foreign banks is expected to improve credit availability for both small enterprises and large investors. Additionally, foreign banks typically increase the volume of stable and long-term loans in the domestic market, contributing to a more robust and reliable financial system.

2.8.2. SOUNDER LENDING PRACTICES

Foreign banks can promote more stable and reliable lending practices by increasing overall capital and liquidity in the banking system. Unlike local banks, which may be limited to domestic sources of funds, foreign banks have access to international capital through their global networks, providing them with multiple options to expand operations. This access enables foreign banks to offer more competitive and diversified financial services, ultimately contributing to economic growth and strengthening the domestic banking sector.

2.8.3. COMPETITION, STABILITY, AND DYNAMIC EFFECTS IN THE BANKING SYSTEM

Foreign banks can contribute to stabilizing financial systems in developing countries. Their international operations allow them to access foreign savings quickly, giving them greater resilience against adverse economic conditions. With larger capital bases and superior managerial expertise, foreign banks are better equipped to navigate the financial turbulence often experienced in emerging economies. Moreover, they play a crucial role in enhancing efficiency, fostering competition, and promoting overall stability in the banking sector.

2.8.4. INTRODUCTION OF NEW BANKING TECHNOLOGIES AND FINANCIAL INNOVATIONS

One key advantage of foreign banks entering Ethiopia's banking sector is their potential to introduce new financial technologies and innovations, which can attract foreign direct investment. Additionally, foreign banks often bring improved standards of accountability, transparency, and financial control, thereby strengthening the domestic banking system and supporting the growth of the financial sector.

2.8.5. DEVELOPMENT OF THE FINANCIAL MARKET AND FOREIGN CURRENCY

Foreign banks can improve the efficiency of national banking operations by providing customers with more accessible and effective financial services. Their participation can accelerate economic growth, increase the availability of foreign exchange, and facilitate international trade by making imports and exports more efficient. The entry of foreign banks is expected to bolster Ethiopia's foreign exchange reserves and help alleviate the country's existing foreign exchange shortage, thereby enhancing the overall stability and functionality of the financial market.

2.8.6. FOREIGN BANKS AS DRIVERS OF DOMESTIC BANK COMPETENCY AND EFFICIENCY

The presence of foreign banks can enhance the competency and efficiency of domestic banks. By introducing additional capital, international banks increase competition and the overall capacity of the banking sector, helping meet the growing financing needs of the economy. The higher quality of service and innovative practices brought by foreign banks not only benefit domestic banks but also improve consumer satisfaction and contribute to the nation's economic potential. Furthermore, foreign banks foster financial growth and efficiency by introducing new banking technologies and innovations. Their experience in sound banking practices, effective financial regulation, robust management and control systems, and risk management strengthens the country's financial infrastructure.

2.8.7. PROMOTION OF FINANCIAL AND ECONOMIC DEVELOPMENT

Foreign banks can directly and indirectly support economic growth by enhancing the effectiveness of domestic banks. Their entry into Ethiopia's banking sector accelerates economic development and stimulates financial sector activities, creating a conducive environment for the sector to achieve international standards.

2.8.8. INTEGRATION OF THE DOMESTIC FINANCIAL SYSTEM WITH THE GLOBAL ECONOMY

Opening the banking sector to foreign banks improves the integration of Ethiopia's financial system with the global economy. Competition between domestic and foreign banks encourages local institutions to adopt international best practices. The presence of foreign banks facilitates foreign direct investment, technology transfer, and the development of professional skills. Additionally, foreign banks introduce new financial products and banking technologies, further contributing to the country's financial development. The expansion of Ethiopian banks abroad and closer integration with the global financial system increase access to international capital and enable them to offer a broader range of services, particularly to large domestic firms engaged in international operations.

2.8.9. ARGUMENTS FOR OPENING THE BANKING SECTOR TO FOREIGN INVESTORS

Ethiopia has recently enacted a law opening its banking sector to foreign investors. Opinions regarding this reform are divided into two main perspectives: those who support the entry of foreign banks and those who oppose it. This division largely stems from differing views on the potential benefits and risks associated with foreign banks' involvement in Ethiopia's banking sector.

Proponents of foreign bank entry argue that it can transform the sector by improving service delivery and increasing financing options for borrowers. Two key benefits are particularly emphasized:

- Access to Global Financial Markets and Enhanced Efficiency: Foreign banks can facilitate integration with global financial markets and introduce modern banking practices, which are expected to improve operational efficiency and promote interbank competition.
- Access to International Banking Networks: Foreign banks provide connections to global banking networks, enabling collaboration with sister banks and other international institutions. This access supports economic development by facilitating international transactions, investment, and financial services.

Overall, opening the banking sector to foreign investors can bring advanced banking knowledge and technology, thereby enhancing Ethiopia's financial system and promoting deeper economic integration with the global market.

3. CONCLUSION

The study's findings indicate that the entry of foreign banks into Ethiopia's banking sector presents both opportunities and challenges. The presence of foreign banks can drive local banks to modernize their services, providing clients with access to global financial products and innovations. It can also encourage the development of new financial instruments, attract foreign direct investment, and facilitate access to international markets. Local banks stand to gain valuable experience, while foreign banks may increase the country's foreign exchange inflows.

Moreover, the introduction of foreign banks supports the transfer of technology and knowledge, giving local institutions access to advanced financial tools, operational strategies, and technical expertise, all of which can enhance industrial productivity and efficiency. Employment opportunities in the banking sector may also expand, particularly if operations are supported by appropriate legal and regulatory frameworks.

Overall, foreign bank entry can help modernize the financial system, bring in new capital, and improve the availability of deposits and foreign exchange, thereby contributing to economic growth. Ethiopia's financial sector has historically been characterized by monopoly, low capacity, limited innovation, low diversity, minimal competition, and a lack of inclusivity. Financial sector liberalization is expected to improve technological and managerial capabilities, increase efficiency, and support long-term economic growth. Additionally, it can enhance the autonomy of the National Bank of Ethiopia by reducing political interference.

However, the entry of foreign banks also poses potential risks. Local banks may struggle to compete unless the National Bank of Ethiopia implements regulatory safeguards or provides support. In times of political or economic instability, foreign banks may shift their resources to safer markets, potentially disrupting domestic operations. This could also incentivize illicit activities such as capital flight. There is a risk of "modern economic colonialism," where foreign banks dominate portions of the domestic financial sector. Additionally, foreign banks may prioritize products from their home countries, and the absence of digital transformation in Ethiopia's banking sector could hinder competition, as local banks may lack the expertise, technology, and skilled personnel to keep up.

Therefore, capacity-building initiatives are essential to modernize Ethiopia's financial system. While challenges exist, the potential benefits of foreign bank participation can outweigh the drawbacks if carefully managed. As the African proverb states, *"Only a fool tests the depth of the water with both feet."* Similarly, Ethiopia should adopt a gradual approach to opening its banking sector, modernizing regulatory frameworks, and establishing a strong legal foundation to ensure sustainable development.

4. POLICY IMPLICATIONS

Based on the study's findings, the following policy implications are drawn:

- As the African proverb states, *"Only a fool tests the depth of water with both feet."* Experiences from successful countries and insights from domestic financial stakeholders suggest that opening Ethiopia's financial sector to foreign investors should be gradual. Moreover, a stable macroeconomic environment should be established as a prerequisite; financial liberalization should not be treated as a solution to existing economic instability.
- Ethiopia should maximize the benefits of allowing foreign banks to operate in the country. To mitigate associated risks, the government must develop a robust regulatory and legal framework, adopt modern banking technologies, strengthen the capacity of local banks, and upgrade the financial system's infrastructure.
- The regulatory body should carefully select foreign bank candidates based on their expertise in banking, willingness to provide financing to micro and small enterprises, ability to transfer technology and knowledge, and other critical factors that contribute to national economic growth.
- To prevent the "cut and run" behavior of foreign banks, capital requirements for foreign institutions should be higher than those imposed on domestic banks.
- Before permitting foreign banks to operate, the National Bank of Ethiopia must establish an efficient and workable regulatory framework. This includes strengthening its leadership and supervisory capabilities, streamlining bureaucratic procedures through legislation, and ensuring effective oversight of banking operations.
- To capitalize on the benefits and minimize the risks of financial liberalization, both local banks and the regulatory authority should prioritize capacity building in areas such as human resources, cybersecurity, technology, and financial management. Continuous research and development investments are essential to improve operational capabilities and foster sustainable growth.
- The National Bank must reduce political dependence, ensure autonomous decision-making free from political influence, and focus on policies and activities that enhance the competitiveness of Ethiopia's banking sector at the international level.

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