Business Environment Reform Facility

Foreign Exchange Allocation and Access for Businesses in Ethiopia (Redacted version)

James Lloyd and Bisrat Teshome

October 2018

BERF Business Environment Reform Facility

UKaid from the British people

About Business Environment Reform Facility (BERF)

BERF is funded by the UK Department for International Development (DFID) under the Business Environment for Economic Development (BEED) Programme. BERF is a central facility responding to demand from the DFID's priority Country Offices and stakeholders to initiate, improve and scale up business environment reform programmes. BERF is managed by a consortium led by KPMG LLP. The programme started in January 2016 and will finish in January 2019.

We provide expert advice, analysis of lessons learned, policy research about what works and what doesn't and develop innovative new approaches to involving businesses and consumers in investment climate reform.

BERF has a strong emphasis on strengthening the Business Environment for women and girls, as well as for young adults more generally. It is also aiming to improve the relationship between business and the physical environment including where relevant through linkage to climate change analysis. BERF recognises the need for appropriate political economy analysis in order to underpin business environment reform processes and interventions.

About this Report

Research for this study was conducted by James Lloyd and Bisrat Teshome between August and September 2018.

The views contained in this report are those of the authors and do not necessarily represent the views of any BERF consortium member or DFID.

This is a working paper shared for discussion purposes only. No reliance should be placed upon this report.

UKaid from the British people

Acronyms and Abbreviations

BERF	Business Environment Reform Facility
CAD	Cash against documents
DFID	Department for International Development
ECRA	Ethiopian Customs and Revenue Authority
FDI	Foreign direct investment
GDP	Gross domestic product
GTP II	Growth and Transformation Plan II
IBD	International Banking Department
IMF	International Monetary Fund
LC	Letters of credit
NBE	National Bank of Ethiopia
SOE	State owned enterprises
TT	Telegraphic transfer
US	United States

Contents

List of Figures

Executive summary

Background

After a decade of double digit economic growth, the Ethiopian economy is at an important point in its transition to a middle-income economy. Rates of economic growth are now slowing and authorities are seeking to shift the engine of economic activity to the private sector. The availability of foreign currency is seen as a severe constraint to the growth and operation of the private sector.

‘Findings

The Birr:US dollar exchange rate is closely managed to maintain the purchasing price of the Birr. While depreciating, the overvalued currency has contributed to a trade deficit which has driven consistent current account deficits. These deficits are being offset by a surplus in the capital account and Central Bank financing. Foreign exchange markets are not clearing, and foreign exchange Directives have been reformed.

30% of foreign currency inflows into commercial banks must now be surrendered to the Central Bank. Allocation Committees in commercial banks must then manage foreign currency exposure and allocate the remaining foreign currency to three areas i) foreign currency requests which should be served on demand, ii) essential foreign currency requests and iii) non-essential foreign currency requests. For the latter two, requests for foreign currency are registered by banks and enter a queue. Daily waiting lists are reported to the Central Bank. At least 50% of the foreign currency allocated to imports is now directed to essential foreign currency requests, with three levels of priority.

Businesses that generate foreign exchange benefit from privileges in accessing foreign exchange. Exporting businesses are able to establish foreign currency retention accounts and use funds held to import. 70% of the incoming foreign currency must be used within 28 days, and 30% can be kept indefinitely. Exporters can use supplier credit, but only so long as it directly finances an export. Foreign investors can take an external loan in limited circumstances. Foreign exchange injected via equity can also be put into a retention account, and used for the investor’s own purposes but it will convert to birr after 28 days. Franco valuta (payment offshore) is available to foreign exporters – strictly speaking only in very limited circumstances such as for payment of urgent spare parts. Franco valuta has been permitted by foreign exporters in practice for broader reasons. Non-resident foreign currency accounts are also available to the diaspora and can be used to import goods.

The foreign currency shortage has led to long delays in accessing foreign currency to import materials and services and businesses do not always receive their full foreign currency request. Delays are expected to be between 4-12 months for essential imports and up to 3 years for non-essential imports, which differ between the banks. Informal payments are likely to be made to accelerate access to foreign currency. Consolidated fees to open Letters of Credit, for a three-month term, in private commercial banks can be as high as 10.25%.

The private sector is being severely affected by the shortage of foreign currency, which is affecting competitiveness. Retailers, wholesalers and import substituting firms are most affected. For example, unit production costs for a manufacturer which exports, interviewed for the assignment, have increased by around 20% and production levels reduced by around 30% because of the shortage of foreign exchange.

Businesses that are more affected by the shortage of foreign exchange are also more likely to use innovative solutions to access foreign currency. These include non-resident (diaspora) foreign currency accounts and the parallel market. There are indications that the foreign currency shortage will ease slightly as exports grow and private transfers increasingly flow through formal channels. However, under the current growth trajectory of exports, foreign currency shortages will remain over the long-term.

International experience confirms that i) Ethiopia is experiencing symptoms associated with an overvalued exchange rate and that ii) overvalued rates have been employed by successful exporters during the early phases of transformation. A more competitive exchange rate will be required as exports become more responsive. The evidence also shows that fixing the nominal exchange rate at levels inconsistent with fundamentals results in an increasingly overvalued exchange rate and foreign exchange shortages. This leads to the creation of informal markets for foreign exchange, while increasing the pressure on authorities to resort to controls or large depreciations, which can both harm growth.

Recommendations

The future challenge will be to adopt an exchange rate that balances the needs of private business with those of the broader economy. In the short-term consideration should be given to a less rigid foreign exchange regime so that businesses can respond to international markets. Authorities may also consider:

- Revisiting, reviewing and revising, where benefits can be demonstrated, the 30% surrender requirement, the time and limits placed on retention accounts and the essential and non-essential lists;
- Aligning the essential and non-essential lists with the second schedule of customs tariffs (maintained by the Ministry of Industry), helping import substitution manufacturing (which needs to spend forex upfront to save it long term) and the definition of goods and services within the lists to commonly used definitions;
- A clearer priority arrangement for capital goods purchases for import substitution manufacturing (not within the second schedule);

- Making Foreign Exchange Operation Guidelines, Foreign Exchange Directives and queue placements more accessible to businesses and the technology system more sophisticated to reduce manipulation;
- Facilitating planning by business and government, and better visibility for investors, to fill import substitution opportunities;
- Permitting minor modifications of LC applications which reflect changes due to goods becoming obsolete etc;
- Improving the management of foreign currency exposure in commercial banks;
- Setting restrictions on banks abusing the foreign exchange position to charge excessive LC charges;
- Allowing for the use of larger telegraphic transfers;
- Simplifying paperwork and reducing logistics and paperwork times, thus reducing the amount of time which forex is blocked or held up for;
- Introducing ex ante and ex post appraisals and effective public-private dialogue into the process of reforming Foreign Exchange Directives.

Donor funded private sector development initiatives have an important role to play in Ethiopia now. Donors are well placed to support the quantity and quality of public-private dialogue, the introduction of evidence-based appraisals, efforts to enhance transparency in allocation and the management of foreign currency exposure in banks and the identification of mechanisms to further encourage private transfers to flow through formal channels. With government authorities disposed to shifting the engine of economic activity to the private sector, businesses require an enabling environment which can sustain Ethiopia’s impressive economic trajectory.

1. Introduction

1.1 Report purpose

The report was commissioned by DFID Ethiopia under the BERF programme, in response to a cross donor initiative led and managed by Enterprise Partners. The report analyses foreign currency access and allocation for businesses in Ethiopia to identify short term solutions to improve allocation and access for businesses. Terms of Reference are in Appendix 10.

This report focuses on the policies and regulations, processes, impacts, comparative experiences and possible solutions relating to foreign currency allocation and access for businesses in Ethiopia. Foreign exchange regimes are only one of the determinants of an economy's competitiveness and reforms in this area require consideration alongside a broader range of issues.

1.2 Report methodology

The methodology deployed was as specified in the Terms of Reference with a one-week research mission to Ethiopia in September 2018. The report relies on secondary sources and interviews. A list of documents consulted can be found in Appendix 1. A short summary of foreign exchange policies and Directives is included in Appendix 2. Appendix 3 includes the results of a case study which demonstrates how the foreign exchange shortage is affecting a representative manufacturing business. Interview summaries with ten Ethiopian business, four international businesses, the National Bank of Ethiopia (NBE), four commercial banks, three associations or institutes and four parallel market agents can be found in Appendices 4 to 8. This wide range of interviews allows for broad conclusions to be reached with a fair degree of confidence. Amended foreign exchange Directives were released during the research, the full impact of which could not be fully identified during the course of this assignment. The amended Directives further tighten foreign exchange allocation, and do not provide greater space for the market to operate.

1.3 Report structure

In line with the objectives of the report, Section 3 reviews governing policies, proclamations, directives and circulars relating to foreign exchange access and allocation. Section 4 then identifies hard currency inflows and outflows over time. In Section 5 the policies and procedures in banks and among businesses are described. The importance of, and practices in, the informal and grey markets for foreign exchange are assessed in Section 6. Section 7 identifies the impact of the foreign currency shortage before Section 8 analyses how long it will take to resolve the constraint through a focus on exports. Key lessons from foreign exchange regime management in cases of heavily involved governments are identified in Section 9. Section 10 then concludes and makes recommendations to ease foreign currency access and allocation for businesses in the short term.

2. Context to foreign exchange policies and directives

After a decade of double digit economic growth, the Ethiopian economy is at an important point in its transition to a middle-income economy. Rates of economic growth are now slowing and authorities are seeking to shift the engine of economic activity to the private sector, while the public sector consolidates. (IMF 2018) This necessitates a consideration of the constraints and opportunities facing businesses. Owners and managers of private businesses interviewed for this report commonly cited the availability of foreign currency as a severe constraint to the growth and operation of their business. The severity of this constraint has increased since 2016.

2.1 Foreign exchange policies

The National Bank of Ethiopia (NBE) is mandated to i) formulate and implement exchange rate policy, ii) manage international reserves, iii) set limits on foreign exchange assets which banks can hold and iv) set limits on the net foreign exchange position of banks. (FNG 2008: 4172) Under the Monetary Policy Framework (MPF), NBE seeks to preserve the purchasing power of the national currency to maintain price stability. (NBE 2009: 2) The headline inflation rate is however high, rising by 4% between the third and fourth quarters of 2017/18. (NBE 2018 (6)) The Growth and Transformation Plan (GTP) II which provides the framework for achieving middle income status for Ethiopia, aims at enhancing export competitiveness within a stable foreign exchange regime. (NPC 2016: 98)

The exchange rate has been closely managed to achieve a depreciation path of 5-6% annually relative to the United States (US) dollar in recent years. (IMF 2018 (2): 12) After the US dollar strengthened the Birr became increasingly overvalued in real effective terms. In response, the NBE devalued the Birr by 15% in October 2017, the first devaluation since 2010. The devaluation resulted in a 17.3% nominal depreciation in the year to June 2018. The real effective exchange rate however only depreciated by 5.9% in the same period because of inflation differentials with trading partners. (NBE 2018 (6))

While the path of depreciation has reduced uncertainty, overvaluation has encouraged demand for imports. The overvaluation has acted as a subsidy to imports and repayments of foreign debt, which has been directed to fund infrastructure. The foreign currency imbalance has been exacerbated by a fall in the international price of and supply constraints in Ethiopia’s primary commodity exports, and further magnified by an expansion in public investment in infrastructure which has increased imports.

In the second quarter of 2017/2018, the balance of payments registered a deficit of US$ 511mn. Gross reserves were sufficient to cover only 2.3 months of imports (a traditional reserve adequacy measure). (NBE 2018: 29) These are below the model based optimal reserve coverage recommendations. (IMF 2018 (2): 32) Authorities have taken a range of measures to address the impact of the foreign currency imbalance on the goals of the GTP II. This has included reforms to foreign exchange controls under NBE directives and guidelines.

2.2 Proclamations and Directives

NBE closely controls foreign exchange transactions under the Bank of Ethiopia Establishment Proclamation and associated Directives, guidelines and letters. (FNG 2008: 4181) The Proclamation provides wide ranging authority and allows for the:

1) Banning of transactions of foreign exchange except with banks or authorised dealers;
2) Imposition of terms, conditions and limitations under which residents and non-residents can possess and utilise foreign currency or instruments of payments in foreign exchange;
3) Imposition of terms and conditions for the transfer of foreign exchange to and from Ethiopia and the settlement of any foreign exchange that results from export, import or transfer;
4) Import or export of valuable goods or foreign exchange to be disallowed unless conditions, circumstances and terms determined by NBE are fulfilled; and,
5) Monitoring of foreign exchange transactions of banks by NBE.

The foreign exchange regime has been liberalised only very gradually. One of the most important steps was the delegation of the management of foreign exchange operations to commercial banks under Directive FXD/07/1998. Since then fifty foreign exchange Directives have been issued. These are complemented by numerous letters and guidelines.

The NBE last published a consolidated version of foreign transaction guidelines and Directives in 2004. (NBE 2004) Businesses (and banks) would benefit from a further consolidated and regularly updated open source repository of relevant foreign exchange Directives and guidelines. The most relevant Directives are described below.

2.2.3 Transparency in foreign exchange allocation and foreign exchange management: Directive no. FXD/57/2018

As the foreign currency shortage worsened the NBE introduced foreign currency allocation requirements to direct foreign currency with the ambition of i) maintaining the stability and credibility of the banking system, ii) protecting the goals of the GTP II iii) and enhancing transparency in foreign currency allocations. The allocation Directives were updated in 2016 and 2017. A new Directive, FXD/57/2018, was then issued in September 2018. (NBE 2018 (2))

The Directive requires a bank's board of directors to put in place foreign exchange operations management guidelines that conform to NBE's Directives. The Directive also ensures bank records and the minutes of Allocation Committee meetings allow for an assessment of compliance with the guidelines, including up to date information on foreign exchange purchase requests and allocations made.

The 2018 Directive distinguishes between foreign currency requests for essential imports (previously called priority imports), non-essential imports (previously called non-priority imports) and requests for which foreign exchange must be sold on demand. Highest priority requests, that are exempt from registration procedures and where currency should be sold on demand, include:

1) Foreign currency requests from foreign employees;
2) External debt repayments (the loans need pre-approval under FXD/47/2017 (NBE 2017 (2)) and supplier credits;
3) Invisible payments (to include payments to Ethiopian diplomatic missions, aviation services and licensed transit companies etc.);
4) Foreign exchange bureaux requests (under FXD/17/2001); and,
5) Foreign currency requests from non-resident foreign currency transferable Birr accounts, retention accounts (under Directive 47/2017) and foreign currency accounts of non-resident Ethiopians and those of non-resident Ethiopian origin.

Second in line for foreign currency are essential imports. Of the foreign currency allocated to imports by banks, FXD/51/2017 dictated that at least 40% must be directed to essential imports. The September 2018 Directive amended this to at least 50%. If the amount destined for essential imports is less than 50%, the difference should be surrendered to the NBE at the mid-rate. Applications for foreign currency for essential imports should be registered and should be served on a first come first served basis thereafter within three levels of priority.

1) First priority:
    a. Fuel;
    b. Pharmaceuticals;
2) Second priority;
    a. Input for agriculture (fertiliser, seeds, pesticides and chemicals);
    b. Input for manufacturing (raw materials and chemicals);
3) Third priority;
    a. Motor oil, lubricants and gas;
    b. Agricultural inputs and machineries;
    c. Pharmaceutical products (laboratory equipment and medical equipment);
    d. Manufacturing businesses requests for procurement for machines, spare parts etc.;
    e. Imports of nutritious foods for babies;
    f. Spare parts for construction machines;
    g. Educational materials (exercise books, ball pen and pencils and printing papers);
    h. Profit and dividend transfer (under the Investment Proclamation);

i. Transfer of sales from foreign airlines; and
j. Sales from the share and liquidation of companies from foreign direct investment (FDI) (under the Investment Proclamation).

Presidents of banks are now authorised to make special approvals for spare parts for machinery and critical inputs for manufacturing and agriculture should production be interrupted.

Letters from NBE to commercial banks clarify the Directives. The definitions of imported items were clarified under FEMRMD236/2016. Under FEMRMD/711/2016 banks were required to report registration queue numbers, approval dates and permit numbers on each permit copy submitted to NBE. A letter dated January 3rd 2018 (FEMRMD/0029/2018) required banks to give signed and stamped registration confirmation slips to applicants showing the queue number, registration date, name of importer, pro forma invoice number and pro forma invoice date and value. The letter also requires banks to i) report queue numbers on a weekly basis, Ii) notify applicants of an allocation with 3 working days of a decision by the allocation committee and iii) send minutes of the foreign currency Allocation Committee meetings to NBE every time foreign currency is allocated. In August 2018, a cloud based system was established which reports the queues to NBE daily, including new registrations and allocations made. FXD/57/2018 requires banks to use this system. This system does not allow for detailed analysis of the queues however, and the queues are only accessible at NBE.

The Directive prohibits allocating foreign exchange from an exporter to an importer outside of the framework described. Manufacturers benefit by not needing to pay the full Birr amount of a purchase order or 30% of a letter of credit (LC) in advance. A letter sent in December 2017 exempted horticulture producers and exporters, which import inputs, from the 100% deposit required when applying for foreign currency through Cash Against Documents (CAD). Banks identify if the business is a horticulturalist or manufacturer at the point of application and this determines the deposit requirements. This frees up company cash flow for exempted businesses as deposits are paid once allocations are approved by banks, rather than during application and prior to being added to the queue.

The Directives also include a number of requirements of banks, including the prohibition of i) declining a registration request from an importer, ii) restricting the number of applications or the value of these that a business can make and iii) making it a condition that importers accept other bank services. Directive FXD/53/2017 seeks to monitor the under invoicing of pro forma invoices. (NBE 2018 (3)). Business applying for foreign exchange for imports are required to define imported items under the eight-digit Harmonised System of Commodity Coding. Banks were directed not to accept a pro forma invoice when prices for selected items are less than the minimum prices indicated by the Ethiopian Customs and Revenue Authority (ECRA) price valuation, or obtained by banks from the international market.

Commentators have complained about the different depreciation rates applied to calculate the minimum values of cars, for example. Banks submit pro forma and their alignment to minimum prices to NBE alongside their weekly submission of foreign currency applications.

2.2.4 Retention and utilisation of export earnings and inward remittance, Directive no. FXD/48/2017

This Directive assists exporters of goods and services in importing and paying external debts, it therefore aims to promote the export orientated industrialisation agenda. It amends Directive FXD/11/1998. (NBE 2017 (3)). Recipients of foreign exchange and exporters can still open foreign exchange retention accounts. The portion of earnings that can now be held indefinitely in Retention Account A increased from 10% to 30%. The remaining 70% can now be held in Retention Account B for a period of 28 days before it is transferred into Birr. These accounts can only be used to finance business-related payments such as i) imports of goods, excluding vehicles, ii) paying external loans, iii) payments to tour operators, iv) payments to conference centres and v) payments for consultants.

2.2.5 Foreign currency surrender requirements, Directive no. (FXD/54/2018)

This stream of Directives enhances government's access to foreign currency, almost all surrendered foreign currency is directed towards importing fuel. Previously banks were required to surrender foreign exchange to NBE that was considered in excess of meeting their day to day needs and commitments falling due within three months. In October 2017 Directive FXD/50/2017 required that banks surrender 30% of their foreign exchange earnings to NBE at the buying rate within the first five working days of the following month. (NBE 2017 (4)). From late August 2018, under FXD/54/2018 the purchase of the surrendered foreign currency was valued at the mid-rate rather than the buying rate. (NBE 2018 (4)) This makes the surrender less punitive on the banks by increasing the Birr amount paid by NBE. The surrender of foreign exchange to NBE limits the amount of foreign exchange that is available to the commercial/business market.

2.2.6 Non-resident Ethiopians and Non-resident Ethiopian origin accounts, Directive no. FXD/55/2018

This stream of Directives aims to encourage non-resident Ethiopians to spend and save their foreign currency in Ethiopia. The Directive allows individuals and enterprises that are non-resident Ethiopians (Ethiopian nationals living, or planning to live, abroad for more than one year) or non-resident foreign nationals of Ethiopian origin (non-resident foreign nationals with identification card attesting to the Ethiopian origin) to open foreign currency accounts in Ethiopia. Time deposit accounts, with a minimum maturity of 3 months, or current accounts are allowed. Interest is only payable, at a rate no more than the LIBOR, if currency is retained in time deposit accounts for more than three months. Only Sterling, US dollar and Euro denominated accounts are authorised, although deposits are allowed in other currencies so long as these were immediately exchanged. Initially accounts were limited at holding 50,000 units of the account's currency. This limit was removed in late August 2018.

FXD/55/2018 tightens up the opening of accounts and deposits into non-resident accounts. (NBE 2018 (5)) Non-residents are now required to submit documents confirming that they are, or are planning to, live and work overseas for more than one year (365 days), and that these documents are subject to renewal. Foreign currency is now only allowed to be credited by the account holder with funds transferred or originating from the place of residence. NBE recently issued a letter stating that the names on the crediting and depositing accounts must match. Mechanisms for crediting include direct crediting from the place of residence and foreign currency cash deposits in Ethiopia, subject to the latter being accompanied by foreign currency declarations from ERCA. Accounts can be used to make foreign payments for imports, provided the account holder holds a business licence related to these imports. This privilege is being used widely by account holders, account holders also act as intermediaries to those wishing to access foreign currency.

Eligible non-residents, such as diplomatic missions, individuals working for them and international organisations and their employees, are also able to open foreign currency accounts in Ethiopia. Non-resident foreign currency accounts are able to keep balances in foreign currency. 100% foreign owned businesses can open non-resident foreign currency accounts and use these for international payments and making payments in Birr locally.

2.2.7 Franco valuta and suppliers credit

In Ethiopia franco valuta refers to a license to import goods on which no foreign currency is payable from the banking system. It is a less commonly used mechanism to import goods. It is governed by Council of Ministers Regulation No. 88/2006. (ERCA 2006) The importation of goods on a franco valuta basis is restricted to use by i) diplomatic missions (such as goods imported with donor money) and ii) businesses that are 100% foreign owned. Technically its use by businesses is restricted to machines up to commissioning stage, or for key spare parts. In practice, NBE also permits it for wider purchases by key businesses. The broader use of franco valuta may clash with ERCA tax requirements. Cases have occurred where ERCA did not recognise expense payments outside of Ethiopia. The recognition of equity in kind contributions e.g. the import of goods as part of a shareholder's equity contribution, also raises concerns. Many of the businesses using franco valuta however benefit from long corporation tax holidays as they export 100% of their production

The supplier credit scheme (NBE Directive 47/2017) allows importers to receive goods from suppliers on short term credit terms provided the business is either i) a domestic business which is both an exporter and the loan is going to finance an exporter or ii) a 100% foreign owned entity with a debt equity ratio of no more than 60:40, with clear loan repayment arrangements and purpose. Loan interest rates are capped by the Directive. Each application is considered on a case by case basis, and banks state that it is unusual for NBE to approve terms longer than six months.

2.3 The design, delivery and enforcement of foreign exchange Directives

NBE regularly releases amendments to existing streams of Directives, as well as new streams of Directives (most recently for foreign currency surrender). The Directives are drafted at high levels of management within NBE, after consultation with other Ministries, Departments and Agencies and are approved and signed by the Governor. Evidence-based appraisals are not conducted. Further private banks, and businesses, have no formal mechanism through which to either be consulted or advocate on reforms to Directives.[1] Private banks and businesses consider their involvement in the, ex-ante and ex-post, appraisal of the Directives as a mechanism through which the Directives and their delivery can be improved.

There is evidence that improvements can be made to regulatory delivery. Regulatory delivery goes beyond the effective design of regulations to consider how regulations are received by businesses, and the manner in which they are enforced. Improvements in regulatory delivery would achieve a more level playing field among banks and businesses. Meanwhile, businesses could be facilitating access to foreign exchange from banks through informal payments. This is despite the high level of bureaucracy in the allocation system. This increases the costs of compliance while reducing the extent to which regulatory outcomes are achieved. The allocation Directive is also open to misuse, as the classifications of imported goods are broad and subject to interpretation.

The Directives include various penalties. For example, banks are subject to a fine of Birr 10,000 for each violation of FXD/57/2018. A bank that does not surrender foreign currency in excess of meeting essential import needs is liable to a fine of US$ 10,000 for each day of delayed surrender, up to a maximum of US$ 50,000. Non-resident Ethiopians that are found to violate the provisions of FXD/55/2018, risk the bank closing their account and having their case reported to NBE.

On the one hand NBE has been quick to enforce matters that risk the credibility of the banking system. Cooperative Bank of Oromia has been penalised by NBE, with the President and Vice Presidents removed, for making foreign currency commitments which it was unable to honour. The bank has been blacklisted internationally. On the other hand, the parallel market in Addis Ababa used to operate in visible sight of key financial institutions, operators that were arrested during the crackdown had reopened operations within 3 weeks. There are few examples of NBE prosecuting cases relating to informal payments to

[1] The Commercial Bank of Ethiopia is an outlier however, this institution is State owned and does have strong institutional linkages with NBE. It often responds to NBE requests to allocate foreign currency to particular importers.

accelerate progress in the queue. Vice Presidents in a few banks have however been removed from their posts by NBE due to a failure to control commission based access to foreign exchange. NBE has seemed more willing to enhance oversight, through the submission of daily queues by banks. Finally, the banks are required to self-enforce the use of non-resident accounts to import goods for other businesses, providing space for banks to turn a blind eye to transgressors. It is possible that NBE considers that the strict enforcement of all requirements of the Directives would result in reduced access to foreign currency in the formal and informal markets, however this should be balanced against the benefits of establishing and maintaining a level playing field.

2.4 Distortions in foreign exchange markets

Market forces play a very limited role in the formal foreign exchange regime. The GTP II proposed to adopt an exchange rate policy that promoted exports. However, the overvalued exchange rate, to protect purchasing power under the MPF, results in exports being more expensive while fuelling demand for imports. These contribute to markets that do not clear and the creation of the parallel market. Foreign currency surrender requirements increase foreign currency shortage in banks.

The imbalance between the supply and demand of foreign currency is worsened by the inflow of remittances through informal channels and the allocation process. These combine to further encourage the operation of the parallel market for foreign exchange operating under a separate rate of exchange. In turn, this encourages smuggling and tax avoidance and the high cost of tradables for households.

3. Hard currency inflows and outflows over time

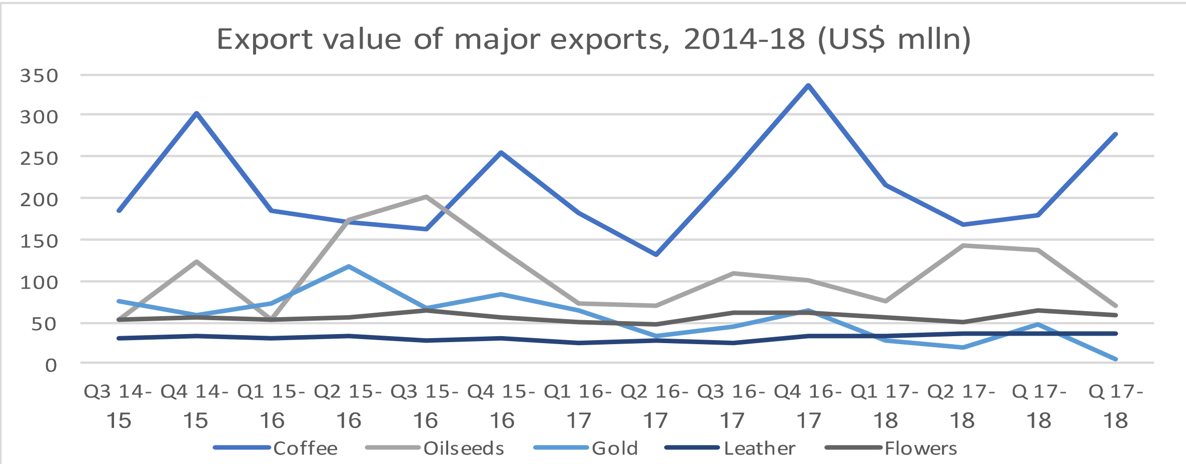
Ethiopia's balance of payments provides insights into the supply and demand for the Birr over time. (IMF 2018 (2)). Under the GTP II foreign currency supply arising from exports, money transfer, FDI and loans and grants was expected to balance with demand from credit for investment, working capital and imports. (NPC 2016: 117) The lack of availability of foreign currency was noted as a risk to the achievement of the goals of GTP II.

Ethiopia's current account was in deficit between 2013 and 2017. The deficit is expected to narrow from 8.2% of gross domestic product (GDP) in 2017 to 5.5% of GDP in 2022. The deficit is driven largely by the imbalance between the import and export of goods. The trade imbalance is expected to remain at around 16% of GDP until 2022. The deficit is being offset by a surplus in the capital account, driven by FDI inflows, other investment and central bank financing. Appendix 9 details selected lines of Ethiopia's balance of payments.

3.1 Hard currency inflows

Exports of goods have not met the forecasts in the GTP II. Exports of goods and services fell from 11.6% of GDP in 2014 to 7.8% of GDP in 2017. The value of exports fell by an average of 1.3% per year between 2013 and 2016, falling from US$ 3.2 bn. in 2013 to US$ 2.9 bn. in 2016. Export values of coffee and other exports grew, while exports of gold and oil seeds fell. Figure 1 shows that the value of each traditional export is volatile, and non-traditional exports have been slow to take-off.

Figure 1: Volatility and slow growth in exports



Source: NBE Quarterly Bulletins, various, 2014-2018.

Exports shrank by 1.8% between the third and fourth quarters of 2017/2018. Coffee exports, which contributes to 25% of total exports, are highly seasonal and increased by 56% while oil seed exports decreased by 49%. Electricity exports increased by 56%. The value of exports from the fourth quarter of 2016/2017 to the fourth quarter of 2017/2018 fell by 17% in total. Figure 2 shows that the value of pulses, electricity, fruits and vegetables and leather products grew, while the value of coffee, oil seeds and flowers fell.

Figure 2: Recent changes in export earnings

Changes in export earnings from key exports, 4th quarter 2016/2017 to 4th quarter 2017/2018	
Product	**% change**
Coffee	-17%
Oil seeds	-31%
Leather products	3%
Fruits and vegetables	11%
Flowers	-2%
Pulses	28%
Electricity	15%
Total export growth	**-17%**

Source: NBE 2018 (6): 57.

The IMF expects the value of exports to increase by an annual average of 13.7% between 2017/18 and 2021/22. Reduced transportation costs, the operationalisation of the industrial parks/export processing zones, investments in hydro power, and policies to encourage FDI and private investment in light manufacturing are expected to support the growth and diversification of exports. Other exports, as defined by the IMF to include leather products, garments, fruits and vegetables, meat and meat products and electricity, currently account for 50% of total exports. Figure 3 shows that other exports will increase their contribution to total exports as exports diversify, and this is where the expected growth in exports is concentrated. After stagnating in 2014 and 2017 other exports are expected to rise by an average of 17% per year between 2018 and 2022.

Figure 3: Long term changes in the value of exports

Changes in the long term value of exports, 2014-2022 (US$ mn.)			
Product	**2014**	**2017**	**2022**
Coffee	714	882	1,484
Gold	456	209	285
Oil seeds	652	350	600
Other	1,454	1,465	3,676

Source: IMF 2018: 24.

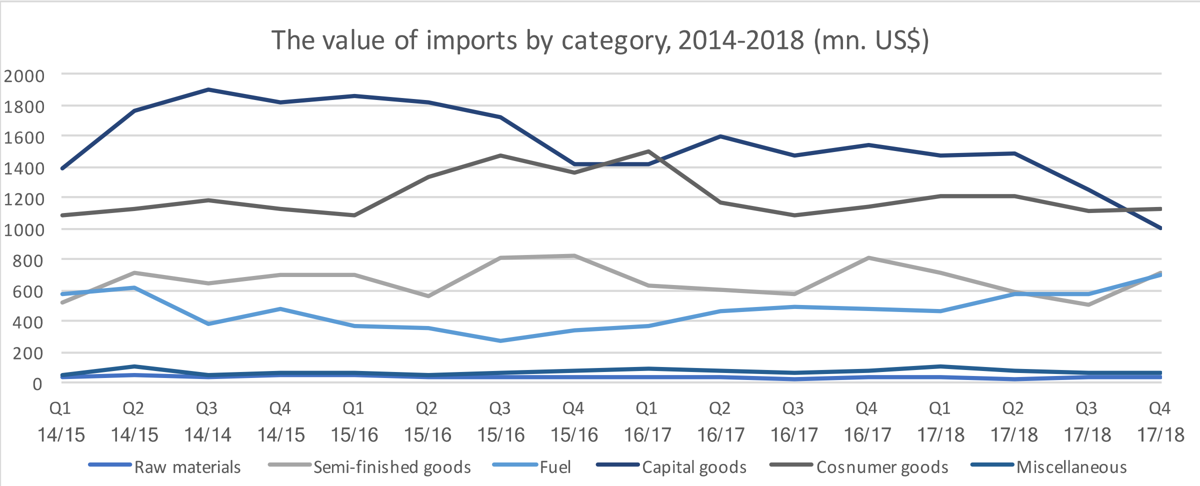
Net private transfers contributed US$ 5,485 mn to the current account in 2017. This contribution is expected to rise by an average rate of 8% per year to US$ 8,590 mn in 2022. Between June and August more private transfers have flowed through formal channels as a hard currency amnesty was introduced and confidence in the management of the economy grew. The parallel market exchange rate hence temporarily fell from Birr 37 to the US dollar to Birr 28 to the US dollar. In August 2018, the Government cracked down on informal market operators in Addis Ababa. The parallel market rate then rose to Birr 35 and remained at this level in October.

Net FDI inflows increased by an average of 30% per year between 2014 and 2017. This growth is expected to continue at the rate of 10% per year to 2022. Net FDI flows were US$ 1.3 bn in the second quarter of 2017/2018, a 53% increase on the first quarter of 2017/2018. The ambition of increasing export orientated manufacturing inflows is yielding results. This ambition is manifested in business income tax exemptions for FDI in strategic sectors, infrastructure development and public investment in industrial parks. These FDI flows are expected to average US$ 618 mn. per year between 2017 and 2022.

3.2 Hard currency outflows

The value of the import of goods has surpassed the projections in the GTP II. The deficit in the current account is driven largely by growth in the demand for imported goods. The value of imports was 20% of GDP in 2017. This value declined slightly in 2017, but is expected to rise by an average rate of 7.5% between 2017 and 2022. The IMF considers an acceleration in imports for business relevant since expanding manufacturing activities will entail the importation of inputs until local sourcing develops. For some inputs and machinery/technology there will never be local sourcing.

Figure 4: Recent changes in the composition of imports



Source: NBE Quarterly Bulletins, various, 2014-2018.

The value of imports declined by an average of 3% per quarter between the first quarter of 2014/15 to the fourth quarter of 2017/18. Figure 4 shows that the contribution of different categories of total imports has changed through the period in which the availability of foreign currency worsened and the allocation and surrender requirements were introduced. Capital goods contributed the largest contribution to total imports in 2014/15, though this contribution has since declined. The value of imports for capital goods for transport and industry declined by 50% and 32% between the fourth quarter of 2016/17 and the fourth quarter of 2017/18. The availability of foreign currency to import and reduced business confidence would have affected the value of capital goods imported. However, this is creating a vicious cycle where import substitution, and subsequent reduced demand for foreign currency, is curtailed. The value of imports of consumer goods was increasing until the first quarter of 2016/17, and then began falling as the foreign currency shortage worsened and allocation directives were introduced. Imports of semi-finished products remained relatively stable between 2014/15 and 2017/18, Ethiopia relies on imported inputs for manufacturing exports. Stimulating local content in this area would help break this cycle through reducing demand for imports. Semi-finished products have been provided a high level of priority in the allocation Directives. The value of fuel imports, to which surrendered foreign currency is directed, has reversed its decline and increased in most quarters since the third quarter of 2015/16. Overall the picture of more recent import values shows the impact of the foreign currency shortage and foreign currency allocation on the value of different imports.

An increase in the inflow of largely public loans has arisen from the overvalued exchange rate, the limited domestic availability of credit and attractive external terms. Other investment, including inflows for Government debt, other public-sector debt, including State Owned Enterprises (SOE) and private debt, contributed to the surplus in the capital account between 2013 and 2017. This positive contribution is set to decline gradually to 2021 and then turn negative in 2022. Importantly, Figure 5 shows that net inflows of other investment, other public-sector inflows (long term) and net private sector borrowing are all expected to turn negative between 2018 and 2022. These are expected to be offset by increases in FDI inflows which will maintain the surplus in the capital account.

Requests for foreign exchange to service external debts are required to be served on demand by commercial banks. Only domestic investors who generate foreign exchange and foreign investments are allowed to access foreign loans under strict approval criteria by NBE. The Ministry of Finance and Economic Cooperation has introduced strict controls on SOE debt. The World Bank and IMF state that Ethiopia is at a high risk of external debt distress, especially in the light of a depreciating currency. Some loans have already been restructured.

Figure 5: Capital account transaction projections

Projected value of key capital account transactions, 2018-2022 US$ mn.					
Transaction	**2018**	**2019**	**2020**	**2021**	**2022**
FDI (net)	4,913	5,446	6,155	6,829	7,124
Other investment	2,061	1,855	974	344	-176
Federal debt	1,565	1,567	1,611	1,600	1,444
Other public sector (net)	505	75	-141	-485	-780
Private sector borrowing (net)	487	750	17	-274	-309

Source: IMF 2018: 24.

4. Processes and procedures in banks and businesses

The Allocation Committee of a bank represents the key decision-making body within commercial banks on foreign exchange matters. Membership of the Committees consist of the commercial bank's President and Vice President and senior management from the bank's International Banking Department (IBD). The Committee assesses and makes decisions relating to the bank's foreign exchange position and transactions. The frequency of Committee meetings differs across banks. In one private bank that the team interviewed which had a larger volume of transactions, the Committee meets once a month and conducts special meetings when needs require. In another bank, the Committee meets once every two months.

4.1 Managing foreign currency exposure in banks

Banks are required to submit weekly returns on their foreign exchange exposure to NBE. The IBD also develops, for use of the Allocation Committee, projections and actuals relating to their foreign currency position. The frequency of these differs across banks. These define the current foreign currency position of the bank and short-term projections of inflows and outflows to assist in managing foreign currency exposure. Major sources of inflows in private commercial banks relate to exports and private transfers, though the relative importance of these across banks differs. Inflows of private transfers are considered to be more stable than inflows arising from exports. These inflows also grew over recent months. In publicly owned commercial banks, official and public transfers also contribute to foreign exchange inflows.

Banks are not always able to meet demands for foreign exchange which must be served on demand (such as from retention accounts and non-resident accounts). This suggests that the quality of projections is not adequately allowing for the management of foreign currency exposure and effective decision making on foreign currency allocation. Banks do have a commercial interest in trading foreign currency, and this demand for increasing revenue and meeting client needs seems to conflict with the effective management of exposure.

4.2 Allocation by banks

The Allocation Committee oversees the surrender of 30% of foreign currency to NBE. NBE says this is all allocated to import fuel. Of the remaining foreign currency, the Committee determines the allocation between invisible payments, which must be served on demand, and essential and non-essential foreign exchange requests. In one private bank, 90% of non-surrendered foreign currency (90% of 70%) usually serves retention and diaspora accounts alone. Even then, these demands cannot always be served on demand. This leaves less than 10% of this bank's non-surrendered foreign currency to be free to allocate to imports.

Commercial banks have developed long backlogs in foreign currency orders. Some foreign currency requests from 2016 have not yet been met. Banks do not expect the backlogs to be cleared over the medium term.

Banks must now allocate at least 50% of foreign currency destined for imports to essential imports. The objective is to clear import backlogs of pharmaceuticals and fuel, and then imports of agricultural inputs (seeds, fertiliser and chemicals) and manufacturing inputs (raw materials and chemicals).

The Banks are required to register businesses that apply for and receive foreign currency on a cloud-based information technology solution. This updated list is transmitted to NBE on a daily basis. Allocations are then meant to be made on a first come first served basis within the essential and non-essential lists.

Allocation Committees in IBD are considered to face a commercial dilemma in allocating foreign currency on a first come first served basis, given the scarcity of foreign exchange. For example, if a client with a loan requires imported inputs in order to meets its loan repayments there would be a risk that not allocating foreign exchange to this business will result in the business defaulting on its debt. Banks can also be expected to face a dilemma when being required to accept foreign currency orders from non-client businesses, when the bank's incentives are to serve long term corporate clients. The scarcity of foreign currency and the needs of businesses have resulted in an environment which is conducive to facilitation payments being used to accelerate access to foreign currency.

NBE has the ability to monitor applications, queues and allocations for foreign currency. Businesses were not able to state if the cloud based system had reduced the incidence of informal payments. Banks are required to submit the details of allocations made on a daily basis, and NBE is responsible for checking queue placements against allocations made.

4.3 Application procedures by businesses

Businesses in Ethiopia use a number of formal mechanisms to access foreign currency. Businesses importing through these mechanisms should have i) a current account with the bank they are using, ii) a valid trade license, iii) a valid tax identification number and should not be iv) reported as delinquent by NBE. Businesses can end up on the delinquency list if there are discrepancies in documents they submit. LC are the most commonly used mechanism.

4.3.1 Letters of credit

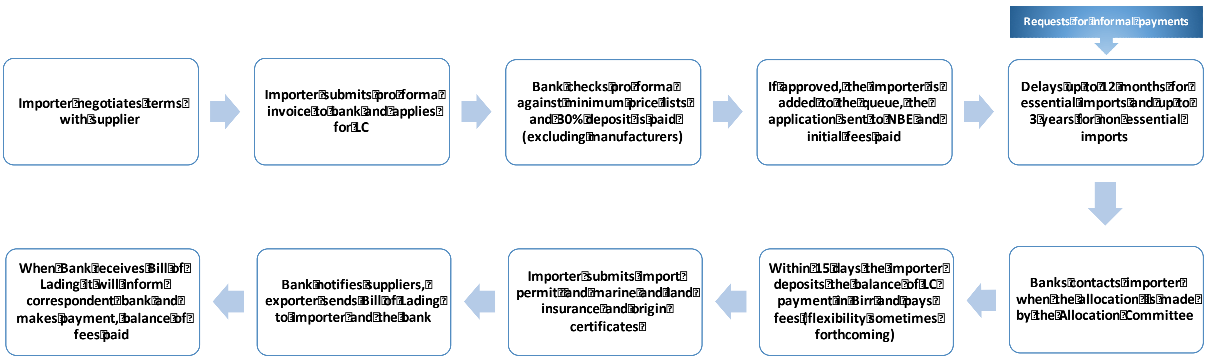
LC guarantee payment for exports or imports between the buyer's or importer's bank to the seller's or exporter's bank. LC can be opened on a revocable and irrevocable basis. Irrevocable LC can be either confirmed or unconfirmed. The processes for application by businesses is similar for each type of LC.

Figure 6 outlines the main steps in the processes followed by banks and businesses in applying for an LC. The delay occurs after the application for foreign exchange joins the queue. Delays in accessing foreign currency vary across banks. Current delays in the month of September 2018 are said to be around twelve months for essential imports, and over twelve months (and sometimes up to 3 years) for non-essential imports. Delays do differ across banks, however. Delays for receiving allocations for essential imports in a state-owned bank were said to be four months, in a private bank they are expected to be twelve months.

Informal payments, to accelerate allocation, are most likely to be made while businesses wait in the queue. These payments average Birr 3 per US dollar requested. Recent reforms to the Directives, especially in the reporting of queue placements aim to reduce the incidence of informal payments, but it is too early to identify how successful these have been.

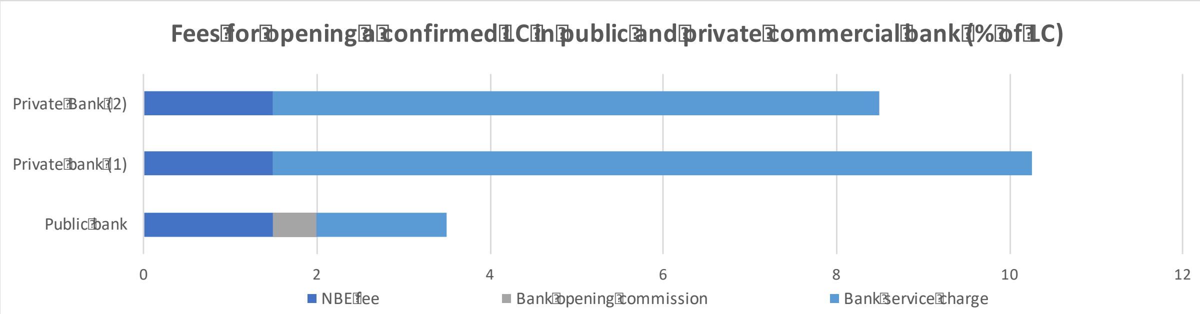
Once foreign currency is allocated to a LC the IBD notifies the importer of the availability of foreign currency. Our interviews suggest that often banks do not always allocate the full value of the LC to the applicant, believing it is better that more clients get some foreign currency than more clients get no foreign currency. This is a particularly common practice in State-owned banks. Businesses regularly receive only 50% of the foreign currency they request. There are also instances of banks not being able to meet their guarantees once LC are approved due to a poor management of foreign currency exposure. This has resulted in instances of foreign banks refusing to deal with Ethiopian banks. Another problem with the delays is that often the imports required by a business change, or become obsolete, during the application period. This can lead to a discrepancy or rejection, and the NBE may classify this as a business delinquency.

Figure 6: The main steps undertaken by a business in importing through LC



Fees are applied by commercial banks, NBE and the SWIFT network. NBE fees are fixed at 1.5% for all foreign exchange transactions. Banks and businesses are unsure why this fee is applied. Bank fees are lowest in a State owned commercial banks. A State-owned bank, for example, applies a charge of only 0.5% for a LC for petroleum imports, compared to 1.5% for a confirmed LC for other imports. Service charges are significantly higher in private commercial banks, and have doubled in the past five years. This perhaps reflects the scarcity of foreign currency and may be more reflective of the market exchange rate. It may also be a way the banks have found of continuing to make the profits shareholders expect given that their ability to make profits on loans is constrained. In one private bank NBE fees and bank service charges total more than 10% of the LC. If facilitation payments are included in this figure, fees, including informal payments, exceed 20% of the value of the LC in one of the private commercial banks.

Figure 7: LC fees in three different banks (% of value of LC)



In Africa as a whole, an African Development Bank survey found that two thirds of respondent banks levied fees below 1% per quarter. (AfDB 2013) The more developed the financial system, the lower the fees. Figure 8 displays the impact of high fees on businesses in Ethiopia. An LC needs to remain open while goods are shipped until arrival, the lengthy transport times and document processing times add additional costs to the cost of importing into Ethiopia. In one bank a portion of fees are charged at approval (60%), with the remainder payable when the goods arrive (40%). This can be negotiated.

Figure 8: International comparison of LC fees

International LC acceptance and opening commission fees to open a LC for US$ 2 mn. pro forma			
Country	**Time period**	**% bank fees**	**US$ cost**
Ethiopia (private bank, exc. NBE fees)	3 months	8.75%	US$ 175,000
Kenya (DIB Bank)	3 months	1.8%	US$ 36,000
United Kingdom (Barclays Bank)	3 months	0.55%	US$ 11,000

Source: DIB Bank, Barclays Bank, interviews

4.3.2 Cash Against Documents

CAD processes are the next frequently used process in Ethiopia. Businesses in Ethiopia are only advised to use CAD when they have a strong relationship with the supplier. Under this process a commercial contract is agreed between the buyer and the seller and goods are shipped. Documents are then delivered from the remitting (exporters) bank to the importers bank, and then the client.

The process for importing through CAD is similar to that used for LC. The main difference is that payment is effected once the documents are received by the local bank. A supplier or exporter that has sold to an Ethiopian importer through CAD presents the local bank with the following documents, i) an original Bill of Lading, ii) a commercial invoice, verified by the Chamber of Commerce of the supplier's country, iii) a packing list and iv) a Certificate of Origin, verified by the Chamber of Commerce of the supplier's country. If the goods are imported from China, a pre-shipment certificate should be presented along with the other four documents. Payment is then made by the presenting (the importer's) bank, and then on to the exporter. Local banks are also required to collect the full payment amount, in local currency, before approving purchase orders under CAD.

The process is administratively less complex than for LC. However, the delays in accessing foreign currency through CAD are the same as for LC and occur while the applicant is waiting in the queue. There are larger variations in CAD fees among private commercial banks than for LC. One private bank charges a fee of 4.5%, in addition to the 1.5% NBE fee. Another bank charges 8.75%, in addition to the 1.5% NBE fee. Compare this with a bank in Kenya, which charges only 0.55% to import under CAD.

4.3.3 Telegraphic transfer

Telegraphic transfers are available to businesses in Ethiopia. However, limits of US$ 5,000 per transfer make this mechanism unsuitable for most large scale importing businesses. Telegraphic transfers are usually used to import small volumes of inputs or pay for consulting fees. One private bank charges 4.5% for TT services. By contrast in Europe there are no limits on telegraphic transfers (only money laundering checks), and maximum fees at Barclays Bank (UK) are £40 (though this bank makes additional income on the exchange rate offered).

Initially, the applicant undertaking a TT submits a pro forma invoice and application for TT. This is then registered on the bank's system and the foreign currency request is added to the bank's system and submitted to NBE. The request will be delayed until an allocation of forex is made.

Delays for TT are similar to delays for CAD and LC. When Forex is allocated for this payment, the following documents are submitted to the bank i) a signed and stamped import application form; ii) a pro forma invoice; iii) an insurance certificate; iv) a copy of valid foreign trade, investment, industry, agriculture or mining license; v) a letter of undertaking for importation of goods; vi) a tax registration certificate; vii) an application letter for the transfer; viii) an original title certificate, for used vehicles, and a ix) third party original price confirmation certified by a Chamber of Commerce. The payment will be effected as soon as the documents are submitted.

4.3.4 Retention and non-resident accounts

Retention and diaspora account holders are authorised to use the foreign currency held in these accounts for purposes restricted by foreign exchange Directives. For example, non-resident Ethiopian accounts are only permitted to import items related to the business licence held by the account holder. Meanwhile forex retention accounts held by forex generating businesses can be employed to import goods, (excluding vehicles), pay loans, pay tour operators, pay conference centres and pay consultants.

Retention and diaspora account holders follow the same processes detailed when importing through CAD, TT and LC as other importers. As they are using their own foreign currency, businesses using retention accounts for imports are not registered, do not queue and their demands should be served on demand. Their LC charges are also lower (although still high – often still 2%). NBE does not charge fees on LC, CAD and TT opened from retention accounts. There are, however, instances when the banks are not able to serve this demand quickly because of the availability of foreign exchange. Retention account holders argue that the limits on the amount of foreign currency that can be held indefinitely, and the time that a portion of it can be kept in foreign currency, should increase. This would allow businesses to be better able to plan imports and investments.

4.3.5 Franco valuta and supplier credit

After a business receives a franco valuta license from NBE, the business progresses import procedures through a local bank by submitting an application and shipping documents. Importers then make payment to their supplier from their off shore foreign currency accounts. A service charge is levied by the banks, this is based on custom authority value estimation slips and has changed between 2% and 1% of the value of imports in recent years.

An investor suggests that this channel is helping to attract foreign investment, which would otherwise be dissuaded from investing due to the foreign currency shortage and extortionate banking transaction fees eating into their investment capital and operating costs. Using franco valuta processes does however deplete the offshore foreign currency account of the business. Policy makers do not consider expanding access to this mechanism as a sustainable solution for Ethiopia's foreign exchange shortage.

Businesses have to apply to NBE in order to be able to utilise credit from suppliers. Applicants require a local bank "advice", customs documents and loan terms. Even though the supplier credit directive is more flexible NBE in practice only approves access to supplier's credit if a company is exporting 100% of its product. The companies use their own foreign exchange to settle their payment to suppliers. Policymakers consider this mechanism as a risk and hence do not actively promote its use. This is because companies defer their foreign currency payments, and these payments must be served on demand by commercial banks.

Shareholder loans by FDI also fall under the same external loan arrangement, and raise the same issues. The foreign exchange arising from the loans is often used to pay for goods, and shareholders are paid back later. They may be viewed more favourably however as shareholders are considered readier to wait for forex than lenders without a long-term business connection.

5. Solutions involving the formal, grey and black markets

Internationally informal foreign exchange markets arise because of restrictions on foreign trade transactions and capital controls. (Agenor 1996) Ethiopia's informal market exists partly as a symptom of disequilibrium and controls in formal markets. It is too easy to mistake the existence of informal and grey markets as a cause of the foreign currency shortage in formal markets.

Businesses have developed innovative methods to access foreign exchange. Methods sometimes involve aspects of the formal market. Businesses are circumventing the shortage of foreign currency in formal markets and exchange controls by i) using the parallel market, ii) starting exports to establish retention accounts and iii) using diaspora accounts.

5.1 The parallel market

Ethiopia's parallel (black) market for foreign exchange is considered to be larger than the formal market for foreign exchange. Some parallel market operators conduct larger volumes of foreign currency transactions each year than some commercial banks. The parallel market is mostly used by male traders and distributors, located in urban areas. The market has seasonal fluctuations. The market is dependent on the shortage of foreign exchange in formal markets and controls, and the higher rate of exchange and political uncertainty which results in the diaspora utilising the informal market.

Parallel market premiums reflect the extent of disequilibrium in the official market. Premiums narrowed after the reform period of 1992 and the introduction of the foreign exchange auction system in 1994. (Degefa 2001) Premiums narrowed again during the hard currency amnesty from June to August 2018. Premiums then widened during the recent crackdown. Businesses state that the parallel market plays 'a very big role' in foreign currency access for businesses. Foreign currency is mostly bought through the Hawala system. Currency is also smuggled over the border.

The Hawala (transfer or trust) system has been modified by local businessmen to transfer money from one country to another, outside formal financial institutions. The system operates through the performance and honour of a large network of money brokers. If a business wants to import items which require payment in foreign currency, it will inform its supplier that a Hawala partner in that country will credit foreign currency to the account of the supplier. When the account is credited, the Ethiopian importer deposits equivalent funds at the parallel market rate in local currency to the local Hawala partner. Goods are then imported, sometimes informally, into Ethiopia. Activists recently lobbied for the diaspora to send money through Hawala, rather than formal channels.

The foreign currency which is smuggled over the border is either i) deposited in a foreign currency account and used to open a LC for import to the port or ii) used directly to purchase goods in the port which are then smuggled into Ethiopia. For goods imported to the port, through an LC opened by a bank in Djibouti for delivery to Djibouti, for example, an Ethiopian business then opens a LC to import the goods to Ethiopia from Djibouti. This has until recently frequently entailed a pro forma that understates prices.

While the parallel market provides an avenue for businesses to access foreign currency, the price of imported goods is increased. This is because the Ethiopian importer passes on a risk premium and the higher rate of exchange in the parallel market, and where relevant two sets of LC fees. Issues also arise from the quality of goods and informality.

5.2 The use of retention accounts

Retention accounts were designed to be used by exporters to support access to foreign currency for imported machinery and inputs. The foreign currency shortage has encouraged non-exporters to begin exporting goods not aligned to their core business just to earn foreign currency and open retention accounts. Earned foreign currency is then used to purchase imports for their core business.

Non-exporters have an incentive to begin exporting in order to open a retention account. This incentive is particularly strong among those supplying manufactured inputs locally which require imported inputs. These exports are likely not always related to the core operation of the business. Under NBE’s Directives foreign currency requests from retention accounts are only allowed for imports that are directly linked to the production of exports. Banks are likely aware of businesses importing goods that are not related to their exporting businesses. Some businesses are innovating in order to export within their core business. One business is investing in research and development in order to access export markets, open a foreign currency account and access foreign exchange for imports from its retained foreign exchange.

The foreign exchange Directives disallow foreign currency being allocated from an exporter to an importer within commercial banks. Interviews did not identify this as a problem, exporters apparently require all of their retained foreign currency to import.

5.3 The use of diaspora accounts

Non-resident accounts were largely intended to be used by diaspora for the purpose of saving their money in their home country. However, this privilege is currently being used by businesses, especially traders, to import through diaspora accounts. Traders resort to using diaspora privileges due to the unavailability of foreign exchange in banks. It is considered a fast, but costly way to access foreign exchange by users of this channel.

Diaspora accounts holders charge a commission of 5-10% of the value of the LC for opening LC on their accounts, in addition to passing on bank and NBE fees. Businesses who agree to pay the commissions have an LC opened for them against the diaspora accounts. These accounts are credited with foreign exchange from international sources who conduct business with diaspora account holders. Ethiopian businesses pay the equivalent LC amount, including fees and commissions, in local currency calculated at the parallel market rate. Recent reforms to diaspora account privileges are not expected to reduce the extent to which these practices occur.

6. The impact of foreign currency shortages

The foreign currency shortage is reducing competitiveness and hampering the growth and operation of businesses in Ethiopia. Unit production costs are increasing as production stalls. It is resulting in businesses ii) laying off workers (especially temporary workers), ii) becoming dormant and iii) ceasing expansion. Businesses that can hold large stocks of inputs due to the lack of clarity of when they will get forex. This affects cash flow, increases warehouse storage costs and risks product loss when inputs expire. These problems reduce investment, employment, value added, revenue generation and return on equity. However, these affects are not being felt evenly across segments of businesses.

Businesses that export or operate in manufacturing and agriculture are less affected.100% foreign owned businesses are also better off as they can use external loans in some circumstances. While those that do not export and operate in retail and wholesale, services and construction are more affected. Businesses in this latter segment are also more likely to regularly use informal and grey markets to access foreign exchange.

Businesses that were expanding or are recently established are also particularly affected. Many expanding businesses have had to halt investments, with capital now tied up in unproductive investments. Meanwhile businesses at earlier stages of their lifecycle have also not been able to build up retained earnings, nor pay back investment capital. Banks are also less likely to allocate forex to newly established companies as they have not built up a relationship in the bank. This now presents risks to the health of balance sheets, as cash flows are affected by the foreign currency shortage.

Case study (details in Appendix 3): An Ethiopian owned manufacturer in a GTP II priority pillar

The business selected for the case study is Ethiopian owned, and operates in a GTP II priority pillar. It relies on six imported inputs. The business was expected to generate a profit of Birr 3.26 mn in 2018. Despite considering a variety of solutions to access foreign exchange, this forecast has recently been updated to a loss of Birr 0.16 mn. Foregone revenue to the Government from corporation tax alone will amount to Birr 0.98 mn in 2018. If the shortage exists for another two years the business will have difficulty in repaying its loans. If it cannot restructure its loans, it will be forced to close.

6.1 Import substitution companies

Companies under this category have indicated that they work, on average, at 40-50% production capacity because of the foreign currency shortage. They often don't receive 100% of their foreign exchange requests, and delays are holding up production. A recent

McKinsey study on the pharmaceutical market in Africa (as yet unpublished) showed that the pharmaceutical manufacturers (nearly all foreign owned) are utilising less than 30% capacity. Import substituting businesses are currently somewhat overlooked as a solution to the foreign exchange shortage. Enhancing local content, especially for intermediate products, in exports and local consumables will reduce demand for foreign exchange. However, business will still require some imports, such as machinery, to meet satisfy local demand. Interviews with businesses highlight cases like:

- An Ethiopian owned cardboard box manufacturing is not taking on new orders or clients and it has laid off 60% of its workers;
  - It takes one year for this business to receive essential imports, and more than one year to receive non-essential imports, the businesses is often only allocated 50% of the foreign exchange they require;
- A joint venture pharmaceutical manufacturer operates at 20% capacity due to the shortage of foreign exchange and has not been able to complete public orders;
  - The business requires 10 different imported inputs which currently face delays of eight months in being allocated foreign currency, having just received imports it expects to operate at 100% capacity for four months;
- An Ethiopian owned button manufacturer, which can supply exporters with import substitutes, has laid off all of its workers and is considering closing down the factory;
  - It takes this business two years to import, they only receive 50% of the foreign currency they asked for
- An Ethiopian owned plastics manufacturer operates at 60% of capacity and has laid off 25% of its workers, it has also shelved its investment plans;
  - This business relies on non-essential imports, it takes more than one year to access foreign currency and the business only receives 50% of the foreign exchange it requires.
- An Ethiopian owned packaging and printing company has stopped using three of its five machines and it is laying off workers;
  - This company has recently only received 50% of the foreign exchange it asks for;
- An Ethiopian owned furniture and woodwork manufacturer is not able to complete its orders;
  - The last time this company was allocated foreign currency was in 2017, the business is aware of businesses making informal payments to access foreign currency;

- A newly established international food processor which supplies local markets has not changed production levels, and is looking to develop local supply chains;
  - The business imports all its inputs through franco valuta, it knows that if it is forced to request foreign currency from banks production will fall.

The reviewed essential and non-essential list in the recent Directives may improve access to foreign currency for import substituting companies, although the drafting in the Directives is vague and doesn't positively encourage import substituting manufacturing. Inputs for manufacturing are listed as a second priority in the essential imports list. A greater level of detail in the classifications of goods and services in the Directives and the harmonisation of this list with other import substitution incentives, such as the second schedule of tariffs (administered by the Ministry of Industry), could provide greater clarity and improve the achievement of outcomes.

6.2 Exporting companies that require imported inputs

These companies are relatively better off compared to import substituting companies. All of the exporters interviewed require imported intermediate products and capital goods, and have established retention accounts to import. These companies will continue to be reliant on imported inputs and machinery until local sourcing develops and often beyond, as for some inputs there will never be local sourcing.

Exporters all considered that increasing the percentage that they can keep indefinitely, and the time that they can keep their remaining foreign currency in retention accounts will assist in further supporting exporters to import and invest. The value derived from establishing retention accounts has encouraged some businesses to begin exporting, just to access foreign exchange for their non-exporting businesses. This suggest that the policy is having unintended benefits which are counter to the Directives. Banks turn a blind eye, and NBE has not yet enforced this requirement.

- An Ethiopian shoe and sole manufacturer operates at 50% of capacity, it has begun exporting to access foreign currency;
  - Export earnings do not however meet its foreign currency needs and it only receives 50% of the foreign currency it requests, the business has considered various solutions to access foreign currency.
- An Ethiopian garment exporter operates at 50% of capacity and has laid off temporary workers;
  - The business uses its retention account but often cannot use the funds within 28 days, it then relies on LC but only receives 50% of the foreign currency it requests.

- An Ethiopian textiles and garments exporter, with other interests in manufacturing, uses foreign exchange earnings from textile exports to import critical inputs for its other businesses;
  - The business only receives 40% of the foreign exchange that it asks for to supplement the foreign exchange it generates.
- An Ethiopian leather tannery that exports hides only receives 40-50% of the foreign currency it requests, the business has stopped its expansion plans;
  - The company is reliant on imports sourced from the bonded warehouse to make up the difference, this is managed by the sectoral association.

6.3 Foreign investors

Newly established foreign investors are able to set up and draw down foreign currency held in non-resident accounts. There is no limit to the time in which this currency can be drawn down. Foreign investors also have particular privileges in being able to access supplier credit and use franco valuta mechanisms, approvals are more likely to be received if the business exports. These approvals are also more likely if the business operates in agriculture and manufacturing. If investors use these channels and also export they benefit from relatively good and cheaper access to foreign currency.

- An international food processor imports all of its inputs through franco valuta channels. It has not changed production levels.
  - The business imports US$ 0.5 mn. of imports each year, without access to franco valuta production would be constrained;
- An international leather processor faces delays in receiving imports which ties up capital in stock, but production levels are not affected;
  - The businesses sources hides locally, but imports chemicals and machinery using either franco valuta or the company's retention account;
- A private equity firm with access to foreign capital will not consider investing in any business that has a high reliance on imported inputs;
  - Devaluation and shortages in foreign currency is said to have reduced imports;
- An international textiles and garments manufacturer uses export earnings to repay its foreign loans through its retention accounts and import;
  - The business faces delays of 8 months to import essential inputs, despite this it is more concerned with the productivity of workers.

Businesses that are located in industrial parks may also benefit from additional mechanisms to access foreign exchange. Consideration has been given to allowing businesses in industrial parks to be able to conduct transactions with each other in foreign currency, but this has not been operationalised. Investors also appeal directly to the Ethiopian Investment Commission to agree tailored solutions. Other options are also explored by large scale investors, such as Peugeot's partnership with the Tigray Endowment Fund.

Foreign investors are likely to be increasingly affected in their attempts to repatriate dividends and profits and proceeds from the sale of shares or the liquidation of foreign investments. The remittance of profits and proceeds from sales is now priority level three under the essential list, compared to previously being a priority foreign currency request. This will mean that requests for profit transfer will likely face a wait while foreign currency is allocated. One private bank acknowledges that in the past the bank would allocate foreign currency to these requests as soon as they were able. Investors from Asia, in particular, are said to repatriate dividends and profits through informal channels as a result of delays in formal channels. One foreign owned business which substitutes imports has re-invested its profits in the hotel industry to avoid the long waiting period at Banks. Retention accounts are not used to remit profits.

6.4 Broader impacts of the foreign exchange shortage

In Addis Ababa, 23% of workers were found to be employed in private casual or temporary positions. (CSA 2015) Businesses are laying off temporary workers to reduce costs. Temporary positions are usually occupied by unskilled and semi-skilled workers. Laying off these workers will reduce incomes of this vulnerable group. Female and younger workers, of both genders, occupy mostly low skilled and semi-skilled positions in locally owned import substituting companies, these are most likely to be laying off temporary workers.

Peaks and troughs in foreign exchange availability lead to surges in foreign exchange being paid into retention accounts. A corresponding surge in imports and a shortage in trucks then leads to goods being delayed. There is a need to consider solutions to logistical bottlenecks in the peaks, and to make foreign exchange available during the troughs.

Though not a focus of this report, consumers are affected by the foreign currency shortage. Foreign exchange controls were expected to decrease the incomes of rural and urban poor households, with rents accruing to the urban non-poor. (IFRI 2009) Consumers are suffering from higher prices for goods imported through the parallel market, shortages in essential goods (including apparently drugs to manage strokes) and services and inferior goods, as a result of smuggling. In some instances, foreign exchange provided by donors could not be accessed by the Ministry of Health, presumably due to diversion elsewhere.

The international and Ethiopian evidence on the existence of parallel markets and taxation is limited as firms do not public tax avoidance or other forms of rent seeking. In Ethiopia incentives that arise from foreign currency shortages and parallel markets are assumed to lead to tax evasion by businesses. Parallel market agents and businesses admit that foreign currency is used to smuggle goods which are sold informally, as well as importing officially through under invoiced pro forma. Losses in public revenues from informality are compounded by losses as a result of subdued economic activity.

7. Addressing the constraint through increasing exports

7.1 How long might the foreign currency shortage last through a focus on exports?

Short term inflows, such as from, official transfers may satisfy immediate needs for foreign exchange, but are not a panacea. A slow growth in exports will gradually increase inflows in the medium term. Despite this, the foreign currency shortage will likely remain a feature of the economy over the long term. Any strategy to address the shortage sustainably would need to tackle the value of imports and exports. Figure 9 shows that if the projected growth rates of exports and imports of 14% and 7% (to 2022) holds over the longer term, the trade imbalance will not be solved. Even with the anticipated growth in exports of electricity and manufactured exports, rates of growth in exports are unlikely to reach the rates required to balance the deficit in the medium term.

Figure 9: Balancing the trade deficit

Required average annual growth in export and import values required to balance the deficit (%)		
Export growth	**Import growth**	**Year trade deficit balanced**
14%	7%	N.A.
330%	7%	2022
70%	2%	2036

Source: IMF 2018 and authors' calculations

7.2 Policy levers

Ethiopia has a range of levers at its disposal to sustainably tackle the trade imbalance. The challenge is to choose the right lever to suit the context. It is currently necessary for authorities to further i) incentivise and enhance capability among business for strategic import substitution, including through enhancing access to foreign currency, ii) further incentivise and provide infrastructure and initiatives to enhance the capability of exporting firms and iii) consider the role of the exchange rate in addressing the trade deficit.

While exporters benefit from benefits in accessing foreign currency, import substituting firms do no benefit from the same focus. This is especially relevant for those that supply inputs used for exports. Bolstering strategic import substitution efforts, especially in manufacturing, will both assist businesses in responding to devaluations as well as reducing demand for foreign exchange in the long term. Resources can also be directed towards targeted local content opportunities for intermediate goods that arise from the foreign currency shortage. Initiatives can adopt an appropriate balance of regulation, incentives and strengthening backward and forward linkages. Reforms to the foreign exchange regime should also continue to be considered against the broad range of effects.

7.3 The reaction of importers and exporters to devaluations

Turning to the response of businesses to movements in the exchange rate. There is a widely held view in Ethiopia that devaluations may not sufficiently grow exports and reduce imports. Several theoretical explanations for this outcome exist. The Marshall – Learner condition holds only when a trade deficit improves after a devaluation as the elasticity of demand for exports and imports is greater than one. This does not always hold due to structural constraints. Secondly if changes in variables, such as national income, are allowed for, the trade balance will only improve if the improvements arising from depreciation more than offset improvements in imports bought about by a rise in national income. Thirdly, the J curve effect dilutes the immediate benefit from devaluation due to supply constraints, most commonly in agricultural produce, and a lack of responsiveness of imports to price movements. The deficit worsens before it improves.

Empirical analysis on Ethiopia suggests that the exchange rate is becoming an increasingly important determinant of exports values of manufactured products in particular. Taye found that devaluations could be expected to improve the current account balance through decreasing expenditure on imports, but not an expansion in exports. (Taye 1999) In 2010, studies concluded that Ethiopia couldn't revolutionise exports through exchange rate manipulation because of structural and institutional factors. (Hassen 2010 and Ciuriak 2010). In 2017 Eshutu identified a J curve reaction to devaluations in Ethiopia, concluding that, despite this, authorities should be conservative in using devaluations to address the deficit through increasing exports. (Eshutu 2017) Policy alternatives were identified to include fostering productivity improvements, diversifying exports and promoting import substitution.

The impacts of exchange rate movements on prices, and how this influences firm behaviour across sectors has received less attention in the international and Ethiopian literature. Mengitsu, using firm level customs and revenue data for Ethiopia from 2006-2014, fill this gap. (Mengitsu et al 2017) They find that a 1% Birr:dollar depreciation results in a 0.9% increase in the value of exports from manufacturers and retailers. Manufacturers respond to devaluations by lowering US dollar export prices, increasing their volume of exports by 1.2% for every 1% devaluation in the Birr US dollar rate. Agricultural firms only increase the volume of exports by 0.4% for every 1% depreciation in the Birr US dollar rate. This shows that exporters of manufactured products, which contribute a small, but growing, share of total exports, will be much more responsive to devaluations than agricultural firms. The response is likely to be more elastic when local inputs are more prevalent in manufactured exports.

Firms are more responsive to Birr US dollar depreciations in terms of their import behaviour. Agricultural firms respond to increases in the value of goods by reducing the volume of imports on a one to one basis, moving towards local suppliers. However local supply constraints do exist. Manufacturing imports remain stable after a depreciation, indicating a need to keep the supply of imported inputs and production steady. This suggests that manufacturers do not change the volume of imports as a result of the increase in price arising from a devaluation. This indicates that policymakers may consider a more flexible devaluation path which would increase the flow of foreign exchange from exports while providing opportunities for import substitution to the manufacturing sector. Strategic import substitution initiatives should therefore be strengthened.

8. Comparative country experiences

The Ethiopian economy is experiencing many of the costs and benefits associated with managed exchange rates, that tend to lead towards overvaluations during the early phases of industrialisation. Benefits include i) cheaper foreign exchange for structural investments, ii) a reduced external debt burden and iii) increased domestic consumption. Costs include i) lower reserves, making shocks hard to manage, ii) exporting businesses with high local content requiring price incentives to overcome higher costs associated with the exchange rate (this is becoming more important in Ethiopia) and iii) rent seeking associated with higher profits in supported sectors and the parallel market which can distort incentives. (Rodrik 2008).

8.1 Lessons in foreign currency management among successful exporters

The generally accepted view on the exchange-rate growth nexus is that a more depreciated exchange rate is conducive to higher growth. (Goncalves and Rodrigues 2017) However, for countries at the early stage of structural change, like Ethiopia, case studies show that the exchange rate is not the primary determinant to increasing manufacturing and exports. This conforms to the literature on Ethiopia. Those economies that expanded manufactured exports have tended to move towards more competitive exchange rates and a liberalised trade regime as exports took off, but these changes did not proceed a take-off in exports. It can also be said that devaluations to increase competitiveness can be contractionary if not adequately sequenced with an increase in the capability of firms to expand price sensitive exports and substitute imports. (Ferrand 2018)

In Korea the exchange rate was only used to incentivise exports during the latter phases of the economy's transformation. The exchange rate became more competitive in 1964 and 1965, and exchange controls were partially liberalised. (Kim 1991) From the 1950s to the early 1960s however the focus was on import substitution, with significant investment in human and physical capital initially coupled with high aid flows and a, not overly, overvalued exchange rate. (Frank 1975) Even in the 1970s the exchange rate was considered at a less than optimal level to incentivise exports as government also wanted to lower its costs for investments in infrastructure. However foreign currency was allocated to companies that performed well in export markets. This trade-off has similarities to Ethiopia's context. In Korea, the government chose to identify sectors and champions, while directing rent based wealth creation towards productive investment. Exchange rates increasingly became part of the incentive structure as exports took off.

Comprehensive capital controls were used to insulate the domestic financial market from the global market. Inward remittances were monitored so that unauthorised foreign exchange transactions and inward investments could be impeded. A parallel market was not allowed to develop. FDI was only allowed into a limited number of sectors, with limits to foreign ownership, requirements for technology transfer and strict export requirements. FDI inflows remained low, and wide-ranging liberalisation to these controls occurred in response to the crisis of the 1990s. (Noland 2005)

Vietnam has mostly operated fixed and pegged exchange rates, with long periods of overvaluations. The parallel market has played an important part in Vietnam's history, reflecting disequilibrium in the formal foreign exchange market, the inflow of remittances and exchange controls. This parallel market has been tolerated, providing access to foreign exchange that could not be funded formally while allowing for the transfer of assets during times of crisis. The real effective exchange rate was said to play only a very limited role in incentivising exports in the short run. This was because of the high import content of exports, with value adding limited to labour. The same is currently largely true in Ethiopia, this will change as the capability of import substituting firms increase. In the long run, the exchange rate was found to not affect imports, but had strong growth effect on exports. (Hoang 2016) Vietnam moved towards a more competitive exchange rate as it side stepped the global financial crisis. These were complemented by ambitious stabilisation policies, such as a fiscal injection of 5% of GDP. (IMF 2010) Since then further outward, market orientated reforms have resulted in a boom in the scale and sophistication of exports.

8.2 Lessons in foreign exchange controls

During the late 1980s and early 1990s it became recognised that widespread exchange and trade restrictions were ineffective in preserving reserves or supporting overvalued exchange rates in many African economies. (Agenor 1992) Evasion became endemic and illegal markets for goods and foreign currency expanded, defeating the purpose of controls. Many sub-Saharan African economies liberalised their economies in response to foreign currency shortages. The countries that reformed successfully made rationing and wide parallel market spreads a thing of the past. (Maehle et al 2013)

In Ghana, reforming the exchange rate occurred gradually, accompanied by fiscal tightening. A unified exchange rate system was achieved. Exports and imports picked up quickly. Kenya liberalised its foreign exchange market in the early 1990s, exports increased sharply and the current account improved markedly. Holders of foreign exchange abroad responded favourably to the liberalised exchange regime, increased interest differential, economic stability and exchange rate expectations and bought their currency back. Exports of agricultural produce, such as French beans, also responded positively to the devaluation. (Mwangi et al 2014) Partly due to this, the current account was in surplus in 1993. Growth also recovered. The experience of successful reformers in this period shows that exchange control liberalisation was a fundamental element of reform, but so were structural reforms, reduced fiscal deficits and monetary expansion, and external assistance. Not all reforms were successful however. Malawi's adoption of a managed float and removal of current account restrictions resulted in rapid inflation. This was because the exchange rate was substantially overvalued, fiscal and monetary policy was overly loose and a drought reduced exports. Malawi reverted back to a heavily controlled regime as a result.

Since the mid 1990's, industrialising economies have been wary of the adverse effects of premature exchange control liberalisation. (Rodrik 1998 and Stiglitz 2002) Having been overlooked, the literature has now begun to investigate the collateral damage of foreign exchange controls on trade. Wei and Zhang (2017) identify three types of exchange controls, i) controls on the proceeds of exports and payments for imports, ii) controls on capital transactions and iii) controls on foreign exchange transactions. (Wei and Zhang 2017) Their analysis finds statistically significant negative effects of exchange controls on trade. A one standard deviation in the controls on foreign exchange transactions reduces trade by the same amount as a rise in tariffs of 10.8 to 11.3 percentage points. Exchange controls operate therefore as a non-tariff barrier to trade, and the damage to trade from imposing exchange controls is found to be sizable. The authors confirm that the delivery of exchange controls will also matter. Corruption in the implementation of controls could primarily weaken the exchange controls, or exacerbate the burden of complying.

The challenge for Ethiopia is to identify which path best suits the broad needs of the economy. The various experiences do not necessarily lead to the conclusion that liberalisation is desirable in itself, but that liberalisation must be done and sequenced sensibly, and suit the local context. In Ethiopia, a major risk from liberalisations surrounds external debt servicing. The economy has been defined as being at high risk of external debt distress by international institutions, and some loans have already been restructured. The full range of risks, costs and benefits of liberalisation, including external debt servicing and imported inflation, are broad and require additional analysis for conclusions to be reached of the most suitable pathway for Ethiopia. However, since exports are likely becoming more responsive to movements in the exchange rate and imports have already shown to be responsive, a less rigid foreign exchange regime seems increasingly appropriate.

8.3 Summarised lessons and recommended pathways

The following lessons can be gleaned from the international experience among successful exporters and with foreign exchange controls:

- Ethiopia is experiencing the symptoms expected from an overvalued exchange rate;
- The exchange rate was not the primary determinant of competitiveness in East Asian success stories, rates did become more competitive and relevant as exports took off;
- In the early phases of industrialisation moderately overvalued exchange rates supported investment and import substitution in these economies, though these did not result in long backlogs in import orders;

- Foreign exchange controls and parallel markets existed in a number of African economies in response to overvalued exchange rates in the 1980s and 1990s;
- In successful reformers, structural reforms occurred alongside monetary and fiscal tightening, foreign exchange rates were devalued, controls were abolished and parallel markets reduced in size; and,

In the short term, as Ethiopia now needs to shift the engine of economic activity to the private sector while the public sector consolidates, a greater consideration of private sector needs relating to the foreign exchange regime, and broader structural reforms, will be beneficial. A greater focus on supporting strategic import substitution, and continued efforts to promote exports, will be an important part of the policy response. This will include reforms to the Directives that enhance allocation and access to foreign exchange to businesses. To achieve this, authorities should consider:

- In the short term, understanding, as fully as possible, the broad range of costs and benefits, and risks and appropriate management strategies, of a path to liberalisation as the structure of the economy continues to change and accompany this effort with accelerated structural reforms;
- In the short term, making reforms to the design and delivery of regulations that determine foreign currency access and allocation to businesses;
- In the longer-term sequencing, timing and coupling the path to liberalisation with continued structural reforms, expansionary monetary policy and reduced fiscal deficits to manage risks; and,
- Continuing to benefit from international assistance, such as financial support packages and technical assistance from donors and multi-lateral institutions.

9. Concluding comments and recommendations

Ethiopia is balancing the necessity of maintaining the purchasing price of the currency, for consumption, investment and debt repayments, with the ability of exporters and importers to respond favourably to price signals through the exchange rate. Markets are not clearing at the current exchange rate, however, and the foreign exchange regime is leading to distortions across the economy.

The future challenge will be to sequence and time a gradual move to a more optimal exchange rate for exporting and import substitution, that balances with the needs of the wider economy. A less rigid foreign exchange regime will allow the private sector to respond to international markets. The assessment of the costs, benefits and risks of such a transition should intensify. Should the only priority be to alleviate the foreign currency shortage, a transition to a market clearing exchange rate may be considered by authorities. Such a transition would require an analysis of the costs, benefits and risks that are outside the scope of this report.

There are now large backlogs of foreign currency orders in commercial banks. The foreign currency position of banks is highly illiquid, with some banks unable to always serve foreign currency requests that should be served on demand. The shortages of foreign currency and delays in receiving imports are crippling segments of the private sector, with retailers and wholesalers and import substituting manufacturers suffering the most. Foreign owned manufacturers that export are least affected. Businesses pursue innovative solutions to access foreign currency in both the informal and grey markets. Businesses that are more affected by foreign currency shortages and controls, are also now more reliant on informal and grey market solutions.

Official transfers may alleviate some of the pressure for foreign currency in the short term. However growing formal private transfers, import substitution and exports provide a more sustainable opportunity for tackling the foreign currency shortage. Authorities may consider ex-post the effectiveness of 'crack downs' versus incentives as mechanisms to transfer the informal market for foreign exchange to the formal market. Efforts to grow exports should, of course, continue. Effort to enhance strategic import substitution should be bolstered.

Regarding reforms to the foreign exchange Directives and their delivery, it is recommended that NBE, in consultation with other relevant Ministries, Departments and Agencies, consider:

- Regularly revisiting the 30% surrender requirement and reduce this as soon as possible;
- Revisiting the time and limits placed on retention accounts so that exporters can utilise more of their foreign currency over a longer period;

- Regularly revisiting the essential and non-essential list so that it meets both the needs of exporters and import substituting firms (closer engagement between NBE, and other Ministries and Agencies and businesses, can support this);
- Aligning the essential and non-essential lists with the second schedule of customs tariffs (maintained by the Ministry of Industry), thereby helping import substitution manufacturers and aligning the definition of goods and services within the lists to commonly used definitions;
- A clearer priority arrangement in the allocation Directive for capital goods purchased for import substitution manufacturing (not within the second schedule);
- The impact of the essential and non-essential list on importing pro poor, poverty reducing finished goods and inputs;
- Improving oversight of foreign currency exposure in banks and supporting improvements in the methodologies employed to project foreign currency inflows and outflows in banks, and their use by the Allocation Committee;
- Permitting minor modifications of LC and CAD which reflect changes due to goods becoming obsolete;
- Encouraging use of larger telegraphic transfers;
- Simplifying paperwork and reducing logistics and paperwork times, thus reducing the amount of time which foreign exchange is blocked or held up for;
- Investigating options for reducing NBE fees for CAD, TT and LC, and understand why there is such a large difference in commercial bank fees;
- Options for reducing logistical constraints when imports surge due to the seasonality of foreign currency inflows from agricultural exporters;
- Establishing a monthly confidence index which collects views from relevant business segments (e.g. exporters, foreign investors and import substituting businesses) to identify how the availability of foreign exchange is changing;
- Engaging with commercial banks and businesses in public private dialogue, on an ex-ante and ex-post basis, to ensure foreign exchange Directives, and their delivery, are fit for purpose; and,
- Making foreign exchange Directives widely available to businesses and the public and improve the transparency of enforcement of bank officers regarding allocation, in particular.

Donors and the international community have an important role to play as Ethiopia navigates this point in its history. International bodies such as the IMF should continue to stand ready in supporting Ethiopia in understanding the costs and benefits of moving to a more flexible foreign exchange regime. This will support sequencing, timing and complementing initiatives.

Donors are well placed to support the quantity and quality of public private dialogue between businesses and decisions makers in government. This will assist in improving the design and delivery of Directives and the achievement of GTP II priorities. The Directives are frequently revised, and the decision-making process is relatively agile and un-bureaucratic. Given the current pace of reform in Ethiopia and the ambition for the private sector to be the engine of growth, now would seem an appropriate time to support these efforts. In addition to regular channels with Chambers of Commerce and other business member organisations, a small group of informed private sector representatives, drawn from priority sectors, could act as an advisory body to authorities on foreign exchange.

Donors are also well placed to strengthen mechanisms that assist in transparency and accountability in foreign exchange management decisions, and the capability of commercial banks. This could include support to updating NBE's cloud based reporting system, and providing training so that banks improve their technical skills to better manage their foreign currency exposure. Finally, donors are well placed to use their knowledge and experience where authorities have successfully implemented reforms to incentivise private remittances to increasingly flow through formal channels.

A number of existing donor initiatives, including Enterprise Partners, are well placed to take these recommendations forward in partnership with authorities. Opening initiatives could then be further supported by anticipated programmes such as Invest Africa.

Appendix 1 Bibliography

AfDB (2013) Trade finance in Africa: Letters of Credit, Africa Economic Brief, vol. 6, no. 1

Agenor (1992) Parallel currency markets in developing countries: Theory, evidence and policy implications, Essays in International Finance, no. 188, Princeton University, New Jersey

Agenor, P and N Haque (1996) Macroeconomic management with informal financial markets, International Journal of Finance Economics, vol. 1, pp. 87-101

CSF (2015) Statistical report on the 2015 Urban Employment Unemployment Survey, Central Statistical Agency, Addis Ababa

Ciuriak D (2010) Supply and demand constraints as barriers for Ethiopian exports: Policy options, bkp Development Research and Consulting www.ssrn.com/abstract=1659655

Degefa, D (2001) The parallel market foreign exchange market and macroeconomic performance in Ethiopia, AERC Research Paper 107, Nairobi

Eshetu, F (2017) Birr devaluation and its effects on trade balance of Ethiopia, Journal of Economics and International Finance, vol. 9, no.11, pp. 103-119

ECRA (2006) The revised regulation on the importation of goods on franco valuta basis, Federal Democratic of Ethiopia, Addis Ababa

Ferrand, A (2018) Exchange rate management and export growth: lessons for Ethiopia, K4D Helpdesk Report: Brighton

FNG (2008) A Proclamation to Amend the National Bank of Ethiopia Establishment Proclamation, Federal Democratic Republic of Ethiopia: Addis Ababa

Goncalves, C and M Rodrigues (2017) Exchange rate misalignment and growth: A myth, WP/17/283, International Monetary Fund: Washington DC

Hassen S (2010) The devaluation of the Birr, a layman's guide

Hoang, L (2016) The role of the exchange rate in supporting trade balance in Vietnam, Graduate Institute of Development Studies, Working Paper Series HEIDWP16-2016

IFRPI (2009) Economic implications of foreign exchange rationing in Ethiopia, Discussion Paper ESSP 009, Ethiopia Strategy Support Program 2

IMF (2010) Staff Report for the 2009 Article IV Consultation with Vietnam, International Monetary Fund: Washington DC

IMF (2018) IMF staff completes 2018 Article IV mission to the Federal Republic of Ethiopia, online, IMF Press Release, available at:

https://www.imf.org/en/News/Articles/2018/09/26/pr18361-imf-staff-completes-2018-article-iv-mission-to-the-federal-republic-of-ethiopia

IMF (2018 (2)) Staff Report for the 2017 Article IV Consultation with Ethiopia, International Monetary Fund: Washington DC

IMF (2018 (3)) Annual Report on Exchange Arrangements and Exchange Restrictions, 2017, International Monetary Fund: Washington DC

Maehle, N, H Teferra and A Khachatryan (2013) Exchange rate liberalisation in selected Sub Saharan African countries: Successes, failures and lessons, IMF Working Paper, WP/13/32

Mengitsu, A et al (2017) The impacts of foreign exchange rate movements on prices and trade across sectors: Evidence from Ethiopian firms, Harvard University, online, available at: https://scholar.harvard.edu/files/emontero/files/ethiopia_fx.pdf

Mwangi, S et al (2014) The effects of exchange rate liberalisation in Kenya on french bean exports, International Journal of Business, Economics and Management, vol. 1, no 4, pp.39-46.

NBE (2004) Consolidated forex services, National Bank of Ethiopia, online, available at: https://www.nbe.gov.et/pdf/Consolidated%20Forex.pdf

NBE (2009) NBE's Monetary Policy Framework, National Bank of Ethiopia: Addis Ababa

NBE (2017) Transparency in foreign currency allocation and foreign exchange management Directive, Directives No. FXD/51/2017, National Bank of Ethiopia: Addis Ababa

NBE (2017 (2)) Amendment of external loan and foreign credit, Directive No. FXD/47/2018, National Bank of Ethiopia: Addis Ababa

NBE (2017 (3)) Amendment of retention and utilization of export earnings and inward remittances, Directive No FXD/48/2017, National Bank of Ethiopia: Addis Ababa

NBE (2017 (4)) Foreign currency surrender requirements, Directive No. FXD/50/2017, National Bank of Ethiopia: Addis Ababa

NBE (2018) Quarterly Bulletin, Second Quarter 2017/18, National Bank of Ethiopia

NBE (2018 (2)) Transparency in foreign currency allocation and foreign exchange management, Directive no. FXD/57/2018, National Bank of Ethiopia: Addis Ababa

NBE (2018 (3)) Setting of indicative minimum price for selected import items, Directive No. FXD/53/2018, National Bank of Ethiopia: Addis Ababa

NBE (2018 (4)) Foreign currency surrender requirements of banks, Directive No. FXD/54/2018, National Bank of Ethiopia: Addis Ababa

NBE (2018 (5)) Establishment of foreign currency accounts for non-resident Ethiopians and non-resident Ethiopian origin, Directive No. FXD/55/2018, National Bank of Ethiopia

NBE (2018) (6) Quarterly Bulletin, Fourth Quarter 2017/18, National Bank of Ethiopia

Noland (2015) South Korea's experience with international capital flows, National Bureau of Economic Research, Working Paper 11381

NPC (2016) Growth and Transformation Plan II (2015/16-2019/20), NPC, Ethiopia

Rodrik (1998) Who needs capital account convertibility? Princeton Essays in International Finance no. 207, Princeton: New Jersey

Rodrik (2008) The real exchange rate and economic growth, John F Kennedy School of Government, Harvard University: Massachusetts,

Shatz, H and D Tarr Exchange rate overvaluation and trade protection: Lessons from experience, Policy Research Working Paper no. 2289, The World Bank: Washington DC

Stiglitz, J (2002) Globalisation and its discontents, Norton: New York

Taye H (1999) The impact of devaluation on macroeconomic performance: The case of Ethiopia, Journal of Policy Modelling, vol. 24, no.1 pp. 481-496

Wei, S and Z Zhang (2017) Collateral damage: Exchange controls and international trade, IMF Working Paper: WP/07/8, The International Monetary Fund, Washington DC

World Bank (2017) Ethiopia: Impacts of the Birr devaluation, online, available at: http://documents.worldbank.org/curated/en/586131512139181555/pdf/121807-BRI-PUBLIC-EthiopiaImpactsoftheBirrDevaluationonInflation.pdf

Appendix 2 Summary of relevant foreign exchange policies and Directives

Under the Monetary Policy Framework (MPF), the National Bank of Ethiopia seeks to preserve the purchasing power of the national currency to maintain price stability. (NBE 2009: 2) This is achieved through a crawl like peg arrangement, which manifests itself as a de facto peg to the US dollar. While depreciating the Birr is still considered overvalued against the US dollar.

Ethiopia's foreign exchange regime is closely regulated. The National Bank of Ethiopia (NBE) is mandated to i) formulate and implement exchange rate policy, ii) manage international reserves, iii) set limits on foreign exchange assets which banks can hold and iv) set limits on the net foreign exchange position of banks. (FNG 2008: 4172). Ethiopia maintains four restrictions which are inconsistent with the International Monetary Fund's Article VIII and is under transitional arrangements under Article XIV.

Directives which affect foreign currency access and allocation for businesses include:

- FXD/57/2018 which requires banks to:
  - Serve invisible payments on demand and then defines foreign currency orders by essential and non-essential items, within the essential list there are three levels of priority;
  - Direct at least 50% of foreign currency directed to imports to essential items;
  - Introduces mechanisms to enhance transparency in allocation, including the reporting of queue placements to the central bank on a daily basis;
- FXD/48/2017 which allows exporters and recipients of regular foreign exchange to:
  - Establish foreign currency accounts, hold foreign currency in two different accounts and use this foreign currency for imports and paying foreign currency loans;
  - In Account A 30% of foreign currency can be retained indefinitely, the remaining 70% can be held for 28 days before being transferred to Birr;
- FXD/54/2018 which requires banks to:
  - Surrender 30% of incoming foreign currency to the central bank at the mid-rate within the first five workings days of the following month;
- FXD/55/2018 which allows non-resident Ethiopians and non-resident Ethiopian origin to
  - Open time deposit or current foreign currency accounts in Ethiopia and allows this foreign currency to be used to import as long as the imports are related to the operations of the business license holder;

Appendix 3 Case study

The business

The business started operations in the 1990's as a 100% Ethiopian owned private limited company. Paid up capital has grown rapidly. The business manufactures shoes and shoe soles. The business therefore operates in a GTP II priority pillar. The business is located in Addis Ababa. The foreign exchange shortage is attributed to misallocation, corruption and a lack of exports. The situation for this company worsened 2 years ago.

The business meets local orders, but has also begun exporting in order to benefit from a retention account. When using all of its production capacity, the business can produce 1,500 shoes per day. The company employs 50 permanent staff and 20 temporary workers. Due to the foreign currency shortage, and delays in accessing inputs for production, the business is operating at 30% of capacity. This short case study investigates the impact of the foreign currency shortage on the i) value of imports made by the company, ii) operating costs and iii) revenue and profits. The case study also identifies how the business is accessing foreign exchange for imports during the foreign exchange shortage.

Importing needs

The business relies on imported inputs and global value chains. All of the imports used in manufacturing were previously identified as priority imports. Under the most recently released allocation Directives the business's imports are identified as a second priority under the essential items list. The business is not certain if this will improve foreign currency access.

The company requires 6 major imported inputs, in addition to machinery and spare parts. When operating at full capacity, as forecasted in the business model, the business should import Birr 13.85 mn worth of manufacturing inputs each year. As the business is operating at 30% of capacity because of the foreign exchange crisis, the business only imports Birr 4.15 mn worth of inputs for manufacturing. The owner of the business says "...if we were to continue operating at full scale, we would have grown our business and continued creating employment for the youth. However, due to shortage of Forex, let alone hiring new workers, we are even forced to lay-off workers."

The business expects the cost of imports to increase slightly as a result of the devaluation of the Birr, but these effects have not been included in the businesses updated forecasts. Despite the devaluation being expected to increase the costs of imports, the business suffers mostly from the availability of foreign currency to access imports. Imports are all invoiced in US$. Imports are sourced from China and India, mainly.

Table 1: Raw materials imports

Raw material imports			
Raw material	**Unit cost / pair (Birr)**	**Annual value at 100% capacity (Birr mn.)**	**Annual value at 30% capacity (Birr mn.)**
Etalstopan / poly	13.52	6.3	1.9
Catalyst	0.23	0.11	0.03
Iso	11.38	5.3	1.6
Colour paste	0.74	0.35	0.10
Methylene	1.22	0.57	1.7
Sistac release agent	2.48	1.16	0.35
Total	**29.59**	**13.85**	**4.15**

Cost schedule

The company has updated its forecast of costs to account for the foreign currency shortage. Unit costs are expected to now be Birr 43 per unit, compared to Birr 35 per unit. The biggest change lies in the cost of imported inputs, which is expected to reduce by Birr 9.7 mn. This takes total manufacturing costs down to Birr 4.3 mn. Salaries and wages were expected to reduce by a third as the company has laid off temporary workers, but is retaining semi-skilled and skilled workers. The owner of the business says "if we were to continue operating at full scale, we would have grown our business and continued creating employment for young people and women. However, due to the shortage of Forex, let alone hiring new workers, we are forced to lay-off temporary workers." Utility costs were expected to reduce, but not in line with overall capacity reduction, as machines must be tested. Depreciation costs were expected to remain stable. A small reduction was expected in bank charges, as a result of reduced bank fees for imports.

Table 2: Cost schedules under original forecasts and updated forecasts

Cost schedule			
Cost	**2018 forecast (100% capacity) (Birr mn)**	**2018 updated forecast (30% capacity) (Birr mn)**	**Difference between forecasts (Birr mn)**
Raw materials	13.85	4.15	9.7
Other manufacturing costs	0.70	0.4	0.3
Inputs sub total	**14.45**	**4.36**	**10.1**
Salaries and wages	0.30	0.20	0.10
Utility	0.04	0.03	0.01
Repair and maintenance	0.07	0.06	0.01
Miscellaneous expenses	0.09	0.07	0.02
Depreciation	.014	.014	0
Depreciation (new)	0.50	0.50	0
Operating costs sub total	**1.01**	**0.87**	**0.14**
Bank charges	0.83	0.75	0.08
Interest expenses	0.06	0.06	0
Financial costs sub total	**0.89**	**0.81**	**0.08**

Cost schedule			
Cost	**2018 forecast (100% capacity) (Birr mn)**	**2018 updated forecast (30% capacity) (Birr mn)**	**Difference between forecasts (Birr mn)**
Total costs	**16.35**	**6.04**	**10.31**

Revenue schedule

Due to the foreign currency shortage, the business is operating at 30% capacity and is only producing 450 shoes per day. This equates to 140,400 units produced each year. The business expects to be able to sell all of its production, and average selling prices were not expected to change in the updated forecasts. Based upon the updated revenue forecasts income from sales was expected to fall from Birr 19.6 mn to Birr 5.8 mn, a reduction of Birr 13.7 mn. This reduction in sales and changes to costs affects profit. Profit was expected to reach Birr 3.26 mn in 2018, this has been updated to loss of Birr 0.16 mn. The difference in profit between the forecasts is Birr 3.42 mn. This results in foregone company tax to the Government of Ethiopia of Birr 0.98 mn.

The business currently operates at a loss despite being considered to operate in a priority sector and having its imports listed as second priority under the essential list. The general manager of the business says "it is very discouraging to work in such circumstances. We see a lot of imported consumable items in supermarkets and similar markets, but we find it difficult to import items that have multiplier effect in the economy".

As the business exports, the business can also make use of its retention account. The business is surviving through using retained earnings to fund operational losses during the foreign currency shortage. Should the shortage exist for another two years the business expects to face difficulties in repaying its loans and will be forced to restructure these loans. If this is not possible, this will result in the business closing.

Table 3: Revenue schedule

Cost schedule			
Description	**2018 forecast**	**2018 updated forecast**	**Difference between forecasts**
Daily production (units)	1,500	450	1,050
Production/year (units)	468,000	140,400	327,600
% of estimated sales of production	100%	100%	0
Estimated sales	468,000	140,000	0
Average Selling Price	41.90	41.90	0
Sales (Birr)	**19,606,860.00**	**5,882,058**	**13,724,802**
Profit (Birr mn)	**3.26**	**0.16**	**3.42**

Accessing imports

The business has investigated a variety of means to access foreign exchange for imports that are described in the main section of this report. The owner of the business says "...I am afraid we could be forced to close down our factory if the situation continues like this. The government has to avail Forex in the short run."

In order to break-even the business must therefore increase its production. The manager considers the exploration of innovative approaches to source imported inputs as a justifiable means to achieve this corporate objective. The business uses the following channels to access foreign exchange for imports of goods and services.

- **Letters of credit:** This is the preferred method to import to Ethiopia by this business, though the business complains that bank fees for LC have more than doubled in recent years, delays are experienced and banks do not allocate the full value of LC. Even though the raw materials of this company were listed as priority imports, the bank takes 8-12 months to open an LC for them. The last time LC was opened, the bank only allocated half of the foreign currency that was requested. This led to both delays in production as well as reducing the number of units the business could produce.
- **Cash against documents:** The business has used CAD in the past. However, the business has not identified a regular supplier in India or China. This is because the nature of their imports, with preferred suppliers being selected based on cost. Trust, which is an important component of business under CAD, has therefore not developed with a preferred supplier. It has been difficult to find a supplier that is willing to export to Ethiopia under CAD processes. CAD fees are similar to LC fees, and the delays expected to be the same.
- **Telegraphic transfer:** The company has imported chemicals and made international payment for technical experts it brought from India through TT. The limit of US$ 5,000 for TT reduces the extent to which this channel can solve the problem.
- **Parallel market:** The Company has considered using the parallel market a number of times. The business only considers using black market to top up the foreign currency received through the formal channel. As banks do not allocate the full value of LC the parallel market can make up the difference.
- **Diaspora Account:** The business used a diaspora account when it imported a company car. The business does not use this mechanism regularly.
- **Exporting:** The business began exporting for the sake of being able to access a retention account. The business used its retention account to open LC for importing raw materials for the factory 5 months ago. However, the business finds the export and import process complicated and is discouraged to continue exporting for the purpose of importing through the retention account.
- **Smuggling out USD:** The firm has not smuggled out US$ over land borders. However, in order to top up the foreign currency for imported items they have considered smuggled out USD through Addis Ababa airport.

The future:

The business does not have any investment plans. Rather than investing, the more likely possibility is divesting. The managers stated that "…businesses like us are exiting the market due to shortages of foreign currency."

The business would like to see sectors getting equal treatment, but given the shortage of forex it considers it important that the allocation is done fairly. The business does not consider the process transparent. The process takes a long time and the business is not sure if this is caused by a shortage in forex or corrupt practices.

The business considers that a large and sudden devaluation to achieve a market clearing exchange rate may present too much of a shock to the system. However, the owner agrees that this would assist in solving the forex crisis. The business would like to see more initiatives to encourage private remittances to flow through formal channels, as well as enhancements in import substitution and export initiatives, in the short term. Over the long run gradual devaluations are expected to achieve a more competitive exchange rate.

Appendix 4 Summary of interviews with local businesses

Local business 1

Business 1 has been producing garments for the past 12 years. Despite being able to use retention accounts the business suffers from foreign exchange constraints. For non-priority imports they wait for more than one year for LC approval, compared to less than one year for priority imports. The delays are similar when using CAD or LC. While the business used to receive 100% of the value of the LC applied for, it now receives only 50%. The business considers that the cause of the crisis stems from i) low exports values, ii) misallocation by banks and iii) insufficient support to exporters. The foreign currency situation is deteriorating. The business is aware of requests for informal payments to access foreign currency, but is not aware of the cost.

Importers of consumer products are considered most likely to use informal channels. The recent crackdown on the parallel market will only reduce access to foreign currency for a short time.

The forex crisis has resulted in the factory operating at 50% of capacity, and has reduced investment. The business has laid off temporary workers, but retained skilled workers. The forex crisis is increasing the cost of operations, and hence affecting the competitiveness of products in the international market.

Local business 2:

Business 2 manufactures buttons. It has been in operation for 5 years. It takes approximately 2 years to open a LC for priority imports, they are still in the list for opening a LC for non-priority imports. The delays are similar when using CAD or LC. The business only received 50% of the amount of foreign exchange requested in their LC. The business suggests the crisis stems from mismanagement, the low inflow of formal remittances and low exports. The forex shortage worsened in the past three years. The business wants its inputs to be included in the priority list as it can substitute imports to the industrial parks.

The business is aware of businesses using informal channels. This occurs because foreign currency is not available. Hard currency is taken over the border and used to buy imports. The business has not used other entities' diaspora accounts, but have heard it is happening. This includes a commission, which makes imports very expensive. The parallel market is said to play a very big role and import and distribution companies are most likely to use it. The recent crackdown on the parallel market will have only a very short effect, with new entrants expected to be operating soon.

The forex crisis has meant that the business is not producing anything at the moment. They are not making any investment, and are not sure how they can survive with existing capacity.

The business has let all of their workers go. Other similar businesses are now expected to also close down.

Local business 3

Business 3 has manufactured cardboard packaging for the past 25 years. It currently takes 1 year to access currency for priority imports and more than 1 year for non-priority imports. They usually receive the value of currency they request, but sometimes this falls to 50%. A lack of exports, remittance mismanagement and contraband trade are said to be the main causes of the crisis. The crisis worsened significantly 3 years ago, and the situation is deteriorating.

Banks are said to give priority to high revenue yielding customers. The business does not know how their LC application is progressing in the queue. The business is aware of requests for informal payments being requested, but they are not aware of the amount requested. The business states that the forex crisis can be partly resolved through exporting more and supporting businesses that import materials to supply to industrial parks.

The business is aware of hard currency flowing out of Ethiopia. This is used to purchase imports. This pushes up the price of living in Ethiopia. The business is aware of diaspora accounts being used for imports for entities without diaspora accounts. Those with diaspora accounts let their clients open LC on their own accounts and charge commission. The commission requested is large. The parallel market is said to play a very big role in foreign currency access and this is most important for importers and distributors. The crackdown is not expected to have a long-term impact on the role played by the parallel market.

The business has reduced daily production by around 60% as a result of the shortage. The business has stopped accepting new orders. The business was considering expanding but has held off until the forex crisis is resolved. Labour inputs have been reduced by 60%. The industry is said to be "...not doing well, there is no use staying in the industry."

Local business 4

Business 4 has been in the plastics business for 5 years. As they are not importers of priority inputs it takes them more than one year to access foreign currency. The delays are similar under the CAD or LC process. The business used to receive the full value of currency requested, but they now receive only 50%. The situation is said to stem from low coffee prices, insufficient exports and corruption. The business would like plastic products to be included as a priority import to support broader manufacturing in Ethiopia. The forex situation is said to be deteriorating.

They see the commercial banks giving priority to their good customers. The business is not aware of requests for informal payments to access forex but considers the introduction of international banks as a possible route to relieving the crisis.

The business hears of the smuggling of forex out of the country. This is used to purchase imports in neighbouring countries. The business is also aware of traders using retention account holders accounts to open LC and receive imports. Commissions are said to be high. The business only uses LC and is not aware of any other mechanisms. The parallel market is said to play a very big role, and these are mostly used for traders of cars and other household items. The crackdown is thought to only affect the parallel market for a few months, but then the market will return back to where it is.

The business is operating at 60% capacity. If they had access to forex they would operate at 80%. They do not have plans to invest, the plan was shelved after access to forex worsened. The business has laid off 25% of workers, mostly in the production team. The broader industry is certainly hurt, and the business expects other businesses to close down soon.

Local business 5

Business 5 has been operating for 25 years in the manufacturing sector and 10 years in textiles and garments. It takes more than one year to access both priority and non-priority imports. The delays are similar when using LC or CAD. The business used to receive 100% of the amount requested, but now receives only 40%. The business puts the cause of the crisis down to mismanagement and corruption. The situation worsened three years ago. The situation is deteriorating. While the bank has guidelines for forex allocation, the business does not consider these transparent. The business says the banks responds to their requests for information with a statement that 'it is in the que.' The business wants to see more government support to local manufacturers that export.

The business is not aware of the smuggling of foreign currency to purchase imports, but is aware of diaspora accounts being used. The account holders import in their name and then transfer goods to the customer's name, with a high commission fee. This process is not considered suitable for manufacturers. The firm only uses LC, but acknowledges that other firms find the black market very popular. Importers of tradables are considered particularly likely to use the parallel market. The crackdown is not expected to have a big effect.

Production has not been seriously affected as the business can import through other businesses. The business has begun production of a new manufacturing plant, but has stopped production due to the forex shortage. It has cut 5% of its un skilled labour force. The broader industry is struggling, some other businesses are said to be closing down and moving to other sectors.

Local business 6

Business 6 envisions operating in the leisure sector. It took two years for the last LC to be approved. While the business asked for US$250,000 it only received US$50,000. The situation worsened 3 years ago. The situation is said to be deteriorating. The business understands the formal process for accessing foreign currency. The business suggests that the economy should generate more US$ and if this is allocated effectively, including to the tourism sector, then the balance of payments issue should be solved.

The business is aware of foreign currency being smuggled but is not aware of the details. The business also hears that diaspora account holders can help to open LC, but they are not aware of the details. The business is not aware of any other means, but sees people importing goods without knowing how they do it. The parallel market is said to play a very big role.

The forex shortage has delayed the completion of the project by 3 years. The investor has only kept on 2 staff until they can import furniture. The tourism sector is said to be one of the most hardest hit by the shortage of forex many hotel constructions have ceased due to the unavailability of forex. The situation is said to be hugely affecting the sector.

Local business 7

Business 7 has been operating a leather tannery for almost over 50 years. It takes them one year to import priority imports and more than 2 years to import non-priority imports. The delays are similar when using CAD or LC processes. While they used to receive 100% of forex requested they now receive 40-60%. The main causes are said to be i) not enough exports, ii) corruption and iii) not enough remittances through formal channels. The situation worsened in the last 3 years and is said to be deteriorating. The business understands the process to access forex and understands there are guidelines. The business has heard of requests for informal payments, but they do not know how much is asked for. The businesses consider that the economy must i) generate more forex, ii) really give priority to priority imports and iii) improve the allocation process to resolve the situation.

Businesses are said to use informal channels because they can't access forex through commercial banks. Businesses have to go to the black market to convert local currency to US$ at very expensive rates. The business does not use diaspora accounts, but is aware that other businesses use the black market, pay bribes and use diaspora accounts. The parallel market is said to play a very big role and is not important for importers of tradable goods. The crackdown is expected to worsen the forex crisis. If the parallel market is not providing forex then forex will be even less available. The business does not see the crackdown as a wise decision.

The business is not able to import chemicals as must as it should do. The business can however use the bonded warehouse system, which allows them to buy chemicals in local currency when it is available (usually chemicals sell out immediately). Production is holding up as a result. The business had begun expanding, but has not been able to complete this due to a shortage of forex. The business has not reduced labour inputs. The industry is said to be the least affected in the country.

Local business 8

Business 8 operates in furniture, woodwork and interior design. It took them 6 months to open their last LC in 2017. They received all the foreign currency they required. Before the shortage worsened two years ago it used to take one month to access forex. The situation is deteriorating. While the business understands the CAD, LC and TT process it does not consider the process transparent – it believes that whoever has money gives the bankers money and is allocated US$. They would like to see more transparency.

The business is has heard of companies who establish companies in Djibouti. Contraband US$ are then smuggled out of Ethiopia to open LC and import goods to Djibouti. They then sell the imported materials at a very cheap price to their Ethiopian company. The business is aware of diaspora accounts being used, but have not used them. Sometimes the business goes to the parallel market. Other businesses ask for favours from relatives abroad. The parallel market is said to be play a very large role.

The business is not able to deliver on orders as a result of the shortage. The business has almost closed its workshop. The entire industry is said to be “being crippled out and prone to fake and cheap products.”

Local business 9:

Business 9 operates in packaging and printing. All of its imports are non-priority, delays are 6 months. Sometimes they receive all the forex they ask for, but sometimes they are offered only 50-60%. The shortage is said to stem from a lack of exports, the misleading priority list and corruption. The shortage started being felt 3 years ago. The business would like to see the priority list amended to support import substituting industries. The forex shortage is said to be deteriorating. The business is aware of the guidelines to access foreign currency, and has heard of businesses making informal payments to access foreign exchange.

The business considers that the informal market fills the gap in the demand for forex. The business is aware of diaspora accounts being used, the business is aware of commissions being requested. The parallel market is said to play a very large role, and this is mostly used by importers of consumer goods, vehicles and construction materials. The recent crackdown is not expected to affect these businesses.

The business has stopped using 3 of its 5 machines. They consider that their production is reduced by half. The business started constructing an expansion project, but due to the unavailability of forex they have stopped construction. Businesses have laid off temporary workers and the broader industry is practically halting production.

Appendix 5 Summary of interviews with commercial banks and NBE

Bank 1:

Bank 1 sources more than half of its foreign exchange (55%) from remittances, with most of the remainder (42%) from flower exports. There are no major changes in the contribution of these inflows to total inflows. Bank 1 states that the forex shortage is worsening.

The Allocation Committee, comprising of the President, the three Vice Presidents and the Manager of the International Banking Department meet when required. They met twice in August and once in September. The bank strictly follows allocation Directives, though acknowledges that not all banks do. Forex Operations Management Guidelines are in use and have been submitted to NBE for review, edits were then made based on feedback. The guidelines were resubmitted to NBE but these were not approved. The bank makes monthly projections on forex inflows, and these are used in the Allocation Committee meeting to determine allocations. When projections are not being met a special Allocation Committee meeting will he held.

The bank is required to surrender 30% of forex to NBE. This is believed to fund government consumption. Of the remainder, usually around 90% goes to invisible payments, such as diaspora or retention accounts, with the remaining 10% allocated to imports. The surrender requirement significantly reduces the foreign currency that is available to the market. Recently 100% of the foreign exchange allocated to imports has been directed to priority imports. The bank last allocated foreign exchange to non-priority imports in May 2016. The bank has US$500 mn. worth of outstanding import orders in the queue. The bank charges 7.25% for an unconfirmed LC, an additional 1.5% is charged as a NBE service fee. 8.75% is charged for a confirmed LC, CAD and TT, with an additional 1.5% charged as a NBE fee.

The Bank considers that NBE should consider engaging more with commercial banks in the design of Directives, the bank would like to see NBE leave more of the allocation decisions to the bank. This would create a more level playing field, as not all banks follow the Directives. The bank reviews Operation Guidelines when required, or when new Directives are issued. Internal compliance audits are conducted daily, with audits by NBE's supervisors conducted twice a year. Each day the priority and non-priority list is submitted to NBE under the new system, this includes new allocations and requests for foreign currency.

The bank can support client importers in using LC, CAD, TT, retention accounts and diaspora accounts for imports. Delays in having non-priority LC approved are around 3 years. Delays for priority imports are around a year. The bank considers that many of the requirements in the allocation Directives are not necessary. It would like to see a greater focus on the importation of medical equipment.

The bank believes that importers of consumables rely very heavily on informal channels to access forex. Chief among these is the parallel market. The bank reiterated that it would like to see more commercial bank involvement in the design of the Directives, the bank has not used a mechanism to engage with NBE with other banks.

Bank 2:

Bank 2 is a privately-owned bank. The bank received US$142 mn. of foreign currency inflows in the last financial year. It sources most of its foreign exchange from agricultural exports, with the remainder coming from remittances and foreign direct investment. The bank sees large changes in the value of foreign exchange inflows from exports. Remittance inflows were a lot larger five years ago, but have shrunk since then. Inflows of remittances grew in recent months. The bank has US$125 mn. of outstanding import orders, and 80% of it is for priority imports. The bank considers that the foreign exchange situation is deteriorating.

The bank has Operations Management Guidelines that meet the requirements of NBE Directives. These were submitted to NBE, feedback was received. The guidelines were then resubmitted. Internal audits are undertaken every two months. The Allocation Committee consists of the President, two Vice Presidents, the Director of the International Banking Department and a Manager. The bank automatically allocates 30% of inflows that it receives to NBE. The remainder is for clients. While the bank understands the needs of the government, the bank suggests that it is its customers that lose out through the surrender requirement. Removing or changing the surrender requirement is considered a quick fix to the forex shortage. When allocations are made for imports, the bank always allocates some foreign exchange to non-priority imports. Under the new Directive which requires forex destined to imports to be split evenly between priority and non-priority imports the bank will expect to complete all non-priority orders before it completes priority orders.

Retention account holders do not use their holdings for imports as their currency is almost immediately transferred to repay local loans. Whatever is remaining we credit to their retention accounts. Fees are 6.5% for an unconfirmed LC and 8.5% for a confirmed LC. The fees for CAD and TT are 4.5%. These fees all include the 1.5% NBE fee. The bank is not always able to serve requests for currency that must be served on demand (retention accounts). The delays faced by businesses in importing are said to be increasing. The bank suggests that its customers care most about the delays and the lack of transparency in allocation.

Traders are said to heavily rely on the black market. The bank would like to see more space provided for the private sector to compete with one another, and less intervention in the allocation process.

Bank 3

Bank 3 is a publicly owned bank, with US$4.3 bn. in foreign exchange inflows in the last financial year. Its largest source of foreign currency is remittances at US$3.7 bn. (consisting of official transfers, public transfers and private transfers). Second is exports, valued at US$586 mn. Remittance inflows are dynamic and change over time, export growth has not been growing so fast. The bank believes that the forex situation is improving. The bank hopes that remittance flows will increase but agricultural exports are not expected to improve. The recent Directive which waives deposit limits are expected to increase inflows of foreign currency. Official transfers are expected to stay stable.

The bank follows Foreign Exchange Directives. The bank follows the foreign exchange surrender requirements of 30% of foreign exchange received each month by the commercial bank. The bank has Operational Management Guidelines, which looks to close any loop holes in the Directives and is updated when Directives are released. The Allocation Committee, consisting of a Vice President and Directors, follows guidelines and data on forex inflows and ques to make informed decisions on allocation.

The bank attempts to meet all forex needs for those in the priority sectors, it often consults with the National Bank of Ethiopia to identify how to allocate resources to which businesses in the priority sector, in particular. This is often by sector, such as agricultural and manufacturing. In some cases, the bank responds to NBE priorities for non-priority sectors. The same is true for state owned enterprises which must operate in the queue, but are sometimes considered to be operating in priority sectors. The bank often responds to urgent requests for foreign exchange allocation from NBE.

The fee for opening a confirmed LC is 3.5%. This includes a 1.5% NBE fee, a 1.5% bank service charge fee and a 0.5% opening commission. The bank has introduced reduced service fees for fertiliser and petroleum imports, for example.

Priority imports are now delayed by around 4 months, last year they were longer than this. The bank acknowledges that they are not able to always give 100% of a LC request. This strategy is adopted so that some importers at least receive something. No allocation has been made to non-priority items recently.

The bank hopes that the Government will redefine the allocation process, priority and non-priority lists, thereby making this fairer. The bank also hopes NBE will consolidate and revise Directives, exporters need forex approval without a queue- the retention account is there, but the utilisation is just for the purpose of exporting and is most useful for manufacturing – it is not useful for all agricultural inputs. The new system for identifying queues is useful, the NBE website allows for customers to check their queue position.

The bank takes a firm position on the parallel market. The bank was not happy to discuss the role of the informal market. However, the bank acknowledges that the informal market exists because foreign currency is not available. It is considered that the parallel market can be bought into the formal sector through providing incentives. The bank only accepts retention account deposits from overseas or deposits in Ethiopia which are accompanied with valid declarations. This will stop foreign exchange from the parallel market being deposited in the remittance accounts for use by importers.

Bank 4:

Bank 4 is a privately-owned bank. In 2016, they mobilised US$291 mn. in forex, this increased to US$400 mn. in 2017. The bank states that the forex crisis is worsening. Exports are not growing, and some companies are exporting at a loss just to generate forex. The bank believes that more effort should be given to import substitution.

The Allocation committee meets regularly and consists of the President, the Vice Presidents and the manager of the International Banking Department. The bank has set out guidelines for operations of forex transactions, this has been submitted to NBE but has not yet been approved. The allocation committee decides on the division of forex between priority and non-priority lists. The wait time for priority imports is said to have very slowly decreased in the last few months. The bank conducts internal audits once a month or so.

Daily submissions are made to NBE on the status of the queue. These importers are served on a first come first served basis. The bank is required to add everyone to the queue, even those that don't bank with them. The bank acknowledges that it faces challenges in treating everyone fairly. The bank is inclined to treat its corporate clients, with loans with the bank, before others so the business can repay the loans. The last allocation was made to priority importers in April 2018.

The foreign currency surrender requirements are said to have had a devastating effect on businesses. This means there is less foreign currency for which to serve customers. The bank believes that the surrender requirements should be reviewed. The bank is not always able to meet demand for forex that must be sold on demand. The bank acknowledges that the cause of the forex crisis is mostly structural, and suggests that there is a very limited role for NBE in solving the crisis. Businesses complain most about delays and the lack of transparency in the allocation process.

The bank considers that the informal market is larger than the formal market for forex. The bank acknowledges that diaspora foreign currency accounts are being used to change forex, and suggests that this is done so the fittest survive. The charge that NBE places on LC (1.5%) is considered too high, and should be reduced. The bank would like NBE to be more open and approachable, this will help technical staff better understand the ramifications of some of the Directives.

National Bank of Ethiopia (NBE)

The National Bank of Ethiopia states that the forex crisis has lessened slightly in recent months. The bank expects that the crisis will continue to alleviate as exports (especially of electricity and goods manufactured in the industrial parks) increase and remittances increasingly flow through formal channels. Official transfers through the Ministry of Finance are also increasing. The importance of formalising the informal market was stressed. The bank however acknowledges that it is balancing the availability of forex with many competing demands, and it is unlikely that the shortage of forex will be resolved over the medium term.

The bank made reference to the newly released Directives as an indication of how it is trying to meet competing needs in the economy. Efforts to improve transparency in allocation, including the submission of daily que lists by commercial banks to NBE, demonstrate the priority that the bank attaches to transparency and fairness. Although the Bank reviews the Foreign Exchange Operations Management Guidelines of commercial banks, the Bank never expected to approve these for implementation.

The bank continues to consider reforms to Directives, such as for allocation, foreign currency surrender and retention and diaspora accounts. Currently almost 100% of the 30% of foreign currency surrendered to the bank is used to import fuel. Conversations within NBE are being conducted as to when this surrender requirement can be removed. The limit on the deposits allowed to be held in diaspora accounts has also recently been lifted, this is expected to increase the flow of foreign currency. The interest rates for time deposit is 14% and for savings account it is 7%. The bank considers this a sufficiently attractive incentive.

Appendix 6 Summary of interviews with associations and institutes

Association 1: Ethiopian Leather Industries Association

This association represents leather exporters. 9 of its members are foreign investors. Exports of leathers have not met the targets in recent years. This is put down to supressed global demand and low prices and low utilisation of capacity in Ethiopia due to shortages in foreign exchange. The association is not seeing a large number of new local entrants into the industry, those that are entering are smaller businesses. New foreign investments are expected. Despite the lack of investment and new entrants, the association considers that the industry is one of the least affected by the shortage of foreign exchange.

Members typically hold retention accounts and use these to import inputs. While the amount that can be held indefinitely has been increased to 30% the remainder can only be held for 28 days. This is not considered a sufficient amount of time to use the foreign currency to import chemicals nor import materials required for expansion.

The association operates a bonded warehouse scheme whereby it accesses foreign currency to open LC to import chemicals. These are prioritised for import. Typically, the bonded warehouse sells all of its stock immediately. This is immediately consumed by businesses.

Institute 1: Chemical, Construction and Input Industries Development Institute

Institute 1 provides services to the chemicals industry. The industry is suffering significantly. Petrochemicals firms (mostly oils and lubricants, semi-finished) work at less than 20% of capacity. There is one fertiliser producer under construction, construction is now stalled partly due to forex availability. Some local businesses have become dormant as a result of the forex issue. The institute has envisioned establishing a committee to investigate and advocate on the forex issue. A company usually gets 10-20% of forex requested and this wait takes 6 months or so. Within this time the price of the LC does change due to the exchange rate, but businesses are not able to change the LC value by more than 10% either way. In recent months, there has been some improvement in forex availability, though this is not expected to be sustained.

Foreign investors can import through franco valuta means, if they receive special authorisation from NBE. However, the Institute considers that the forex crisis is having a very large impact on attracting new foreign investment or expanding existing foreign investment in the economy. The Institute is aware of some special privileges being provided to businesses which results in forex being made available. The Institute does not see chemicals companies using informal channels. However, the Institute does consider that some companies try to influence the allocation of forex. The Institute considers that the only long-term solution is a significant increase in exports.

Association 2: Oromia Chamber of Commerce

The Oromia Chamber of Commerce highlights that the forex situation is the most severe issue facing members. The Chamber says that the major issue is the allocation of the foreign currency, as Ethiopia is transitioning the Chamber considers the availability of forex as a necessary, but unfortunate, growth pain. The Chamber is not certain if the situation is improving or deteriorating, recent improvements such as the inflows of official and private remittances could prove short lived. The black market is said to play a huge role in the availability of foreign exchange.

The Oromia and Ethiopian Chambers of Commerce consider that the availability of forex is the biggest issues facing private sector development in Ethiopia. The Chambers of Commerce have recently engaged in dialogue with the Prime Minister to advocate for changes to the forex regime.

Appendix 7 Summary of interviews with international businesses

International business 1:

International business 1 is considered a local pharmaceutical manufacturer for the purposes of foreign exchange access. The business produces pharmaceuticals. The business used to be a joint Sudanese and UK venture. Now the business is owned by Sudanese, Saudi, Yemeni and Ethiopia investors. The Ethiopia ownership level is the lowest. The business is categorised as a medium sized company. The business has 2 lines, 1 veterinarian line and 2 human lines. The business participates in Government tenders, through the Pharmaceutical Fund Supplies Agency. The Agency requires that a certain percentage must be allocated locally each year, of this amount some is allocated to the company. The company have recently only been capable of supplying 20% of the tender because of the forex constraints. The other 6-7 local companies are also considered to operate at this level of capacity. 100% of this produce supplied goes to government owned hospitals. There are also international tenders which are highly competitive, and which the business participates in.

All of the inputs are imported. The business requires around 10 different inputs to each product line. If one is not available the product cannot be produced. The last time the company ordered forex it received an allocation after 8 months, the business received 100% of the forex it requested. As this import has just arrived, the business expects to be able to operate non-stop for the next four months. The company considers that the situation is slowly improving.

The business considers that the list, submitted by NBE, is assisting with transparency and allocation. The association advocates to banks on behalf of the business to allocate forex. The business often benefits from small inflows of forex from investors to fund specific inputs when production capacity is reduced as a result of forex constraints. The Food and Beverage Institute under the Ministry of Industry can write letters in support of businesses to access forex. The business is aware that it can import through franco valuta means if they use the Food and Beverage Institute. The business is not aware of the availability of suppliers' credit. The business is hoping to export, and is conducting research and development to further this. This will assist in opening retention accounts.

International business 2:

International business 2 is a private equity firm. It is newly established and attracts capital into investable Ethiopian businesses. Though it only considers companies that rely on less than 80% of its inputs being imported inputs, this is because of the shortage of forex. The company feels that the forex situation is neither deteriorating nor improving, it is still taking over 6 months for a priority list LC to be approved, and non-priority list LCs are taking more than 2 years. The business states that imports have decreased recently, and this is because of the devaluation together with forex not being available.

The business says the informal market exists because of disequilibrium in the formal sector. It plays a very large role, but results in increased prices. The business suggests that crackdowns will not achieve intended goals.

The business suggests that the most appropriate quick fix would be to allow the rate to depreciate so that the market clears, the overvalued rate leads to distortions across the economy. The business also suggests that all businesses, both foreign and local, should be allowed to use franco valuta. The business suggested that the diaspora account is further distorting the market. To boost supply, the business suggests that IFC, and other institutions, lend forex to local companies. The business suggests that international loans should be expanded to include forex generating activities, or activities that substitute imports. The business would like to see the government focus on a small number of ‘champions’ which can rapidly grow forex. The business agreed that reducing the surrender requirement would increase the availability of forex to business, but did not agree that bank charges should be capped- suggesting that this would restrict price signals. The business suggests that more official assistance from donors would help to resolve the forex in the short term. The business suggests that guaranteeing banks’ ability to honour LC would increase moral hazard, and would not solve the underlying problems of forex allocation and access. The business does not agree with that supplier’s credit solves the underlying issue, arguing that this pushes the problem down the road.

International business 3:

International business 3 is a food manufacturer, it does not export. The business has been operating in Ethiopia for 3 years. It imports packaging, seasoning and cooking oil. Total annual imports are valued at US$500,000. The business is allowed to use the franco valuta process to import. They do this for all their imports. The business does not have a foreign loan. The business considers that access to forex is a national issue, and this will continue at least for another five years.

The business considers that if it starts to use processes such as letters of credit, it will face a shortage of forex. The business considers that the availability of forex has improved in the past five years. The business does not export and so does not use retention accounts. The business hopes that Government makes long term plans to address the issue and focuses more on import substitution.

The business understands that many other foreign businesses have reduced production by more than 50% as a result of the forex shortage. To date however, investment by the business has not been affected by the forex shortage. Labour inputs remain unchanged. The business is trying to develop local suppliers, especially for cooking oil and plastics.

International business 4:

International business 4 produces textiles and garments. It has been operating for two years. It imports dying agents, cotton, chemicals and accessories. It currently takes the business more than 8 months for LC to be approved. The business only imports essential items. The business only used CAD and TT processes when setting up, then the availability of forex was a lot easier. The business always receives the amount of forex that it asks for. The bank using export earnings to pay for its foreign loans through the businesses retention account. The business suggests that a lack of exports, short sited polities (such as the banned export of cotton) and mismanagement are contributing to the crisis.

The business suggests that the forex crisis is deteriorating. However, the essential and non-essential list is considered appropriate. The business states that it fully understands the process for LC, and says that the bank has published its guidelines. The business however does not consider the allocation process transparent, the business is aware of some businesses bribing bankers to jump the queues for forex.

The business is aware that traders and distributors use informal foreign exchange markets, but does not consider that the crackdown is an efficient means to manage the parallel market.

The business is struggling to meet efficiency levels due to the low productivity of workers. The business is more concerned about low productivity than forex. The business sometimes uses the franco valuta mechanism to import priority items. The business is considering entering into a new investment, but since the banks are not providing LC the business cannot import machinery and equipment. Local manufacturers are said to be particularly affected, with some businesses shutting down.

Appendix 8 Summary of interviews with parallel market agents

Parallel market agent 1:

Parallel market agent 1 is based in Addis Ababa. The agent has been in the business for four years. The agent serves Ethiopians travelling outside of Ethiopia (vacation, conferences, medical travellers etc.) as well as businesses. Among businesses, most are importing cars, mobile phones, clothes, perfumes and electronics. The average trade is US$50,000. The agent usually serves each regular business client every two months. Most trades require transferring Birr into US$. The agent says that the level of control at the airport is a key determinant of volumes of transfers. When controls are high, small amounts are transferred. When controls are low businesses will take large amounts.

The agent says that the parallel market exists because there is not enough supply from banks. Companies therefore use the parallel market to access foreign currency which is not available from the banks. Diaspora Ethiopians prefer the parallel market as it provides a better rate to family and friends. Further diaspora prefer using the parallel market because of political problems. The agent usually uses the Hawala system, under this system the parallel agents has a correspondent partner in a trade centre such as Dubai, Bangkok, Washington and London. Say the client wants to import car parts from China the client asks for foreign currency from the agent. The agent then asks his partner in Beijing to credit the account of the seller of spare parts with the foreign currency. The importer of the spare parts then pays the equivalent sum in local currency exchanged at the black-market rate to the agent. Foreign currency is also smuggled out of Ethiopia through the airport and border trade for bringing items into Ethiopia. The agent says that the forex shortage exists because of political problems.

The agent calls large black-market operators every morning to ascertain the parallel market rate. Then based on the need for forex, the agent makes small adjustments to the exchange rate they offer clients. Sometimes the agent will reduce the price without consulting the big players. When banks increase the supply of forex, which is rare, the agents will adjust their rate accordingly.

The crackdown has scared the market, but this is said to be not the first time this has happened. In previous years colleagues of the agent were detained, but were then released on bail. The agent used to get lots of business in border towns and will continue doing business there. The agent does not consider that the government can control the parallel market. The recent crackdown has led to the disbursement of the market, business is now done by phone and cars and in border towns such as Jigiga, Degehabur, Aware, Moyale and Metema. The crackdown did effect the rate the agent offered, it was almost trading at official rates. It has since returned back to where it was. The agent considers that if the supply of foreign currency in banks was increased, the parallel market would not exist.

Parallel market agent 2:

This agent serves clients which import most consumables into Ethiopia. The minimum trade is US$5,000, and the maximum trade conducted is US$ 1 mn.. The agent is aware of some market agents who trade more than this amount each day. This amount is more than the annualised volume of forex coming into some commercial banks. Sometimes the agent sees clients once a month, sometimes daily, there are seasonal variations in the market. The agent mostly changes Birr into US$.

The agent considers that the parallel market exists because traders cannot get US$ from banks. Manufacturers and agribusiness in the formal sector do not use the parallel market, whereas importers and distributors do. The diaspora uses the parallel market as the rate is better that the official rate, and there is limited trust in government. The agent knows that businesses use the hawala system to credit accounts internationally while local currency is changed in the local informal market. Businesses also smuggle foreign currency out of the country through boarders and airports. There is a high level of suspicion that Chinese manufacturers and other FDI in Ethiopia are using the hawala system to repatriate profits as formal channels are not available due to the unavailability of forex. The foreign currency shortage is said to exist because of a lack of exports and a loss of trust in government.

The agent says that no one knows how the rate is determined. The recent crackdown was said to not have had a large impact on the volume of trades. The recent amnesty did however reduce the rate between the parallel market and the official market. The agent considers that increasing the supply of forex through banks will narrow the differential between the two rates.

Parallel market agent 3:

The volumes of trades this agent conducts is season dependent. Average trades are around US$10,000. The business may see each business once a month. Clients usually change Birr for US$. The parallel market is said to play a very big role in the survival of the agent's business clients.

The parallel market is said to exist because of the limited supply of forex from banks. The diaspora prefer to use the informal market as they get a better rate. The agent is aware that businesses use the Hawala system for importing through parallel market agents. Money is also smuggled out through the airport.

The agent considers that that big players set the rate each day. The recent crackdown is considered a temporary shock, but the market has continued without a problem. The amnesty did reduce the exchange rate in the parallel market temporarily, but is has now returned to higher levels. The agent considers that the only way to narrow the rate differential is to increase the supply of forex from banks.

Parallel market agent 4:

The agent has formal sector business clients that operate in retail and distribution, the average trade is US$20,000. Each client is seen once a month. The agent considers that the parallel market exists because there is no forex in banks. Diaspora are said to prefer the parallel market as the rates are better. Money that is changed is mostly used through the Hawala system. The agent considers that the forex shortage in the formal market is the result of political instability and a lack of exports.

Each morning the agent is given an exchange rate by the big operators. The recent crackdown was said to have not had an impact on the informal market. While the amnesty reduced the rate temporarily. The agent considers that the best way to narrow the rate between the markets would be to increase the supply of forex in banks.

Appendix 9 Ethiopia's balance of payments, 2013-2022

Selected lines of Ethiopia's balance of payments – 2013-2022 (mn. US$)										
Account	Sub account	13/14 Act	14/15 Act	15/16 Act	16/17 Act	17/18 Proj	18/19 Proj	19/20 Proj	20/21 Proj	21/22 Proj
Current account balance		**-3,567**	**-6,579**	**-6,574**	**-6,551**	**-6,497**	**-6,613**	**-6,526**	**-6,430**	**-6,367**
As a % of GDP		-6.4	-10.2	-9.1	-8.2	-7.7	-7.5	-6.8	-6.1	-5.5
Excl official transfers		-5,255	-8,087	-7,965	-7,979	-8,023	-8,188	-8,148	-8,133	-8,142
	Trade balance	-9,929	-13,439	-13,857	-12,895	-13,852	-14,358	-15,174	-16,068	-17,062
	Export of goods	3,277	3,019	2,868	2,908	3,343	3,834	4,455	5,190	6,045
	Import of goods	-13,206	-16,459	-16,725	-15,803	-16,924	-18,192	-19,629	-21,258	-23,108
	Services (net)	712	124	-246	-61	15	158	325	536	774
	Private transfers (net)	4,115	5,490	6,429	5,485	6,089	6,637	7,367	8,103	8,590
Capital account balance		**3,950**	**7,381**	**7,530**	**6,688**	**6,974**	**7,301**	**7,128**	**7,172**	**6,948**
	FDI (net)	1,467	2,202	3,268	4,171	4,913	5,446	6,155	6,829	7,124
	Other Investment (net)	2,483	5,179	4,262	2,517	2,061	1,855	973	344	-176
	Federal Government	2,084	2,567	1,567	1,388	1,565	1,567	1,611	1,600	1,444
	Other pub sector (long term net)[2]	373	2,228	2,146	626	505	75	-141	-485	-780
	Private sector borrowing (net)	0	350	451	503	487	750	17	-274	-309
Overall balance		**-97**	**-521**	**-831**	**-658**	**477**	**688**	**602**	**742**	**580**
	Financing	97	521	831	-658	-477	-688	-602	-742	-580
	Central bank (net)	-46	-93	976	-555	-477	-688	-602	-742	-580
	Commercial bank (net)	143	614	-145	-103	0	0	0	0	0

[2] Includes net borrowing by state owned enterprises and NBE time deposits

Source: [IMF 2018: 24]

Appendix 10 Terms of Reference

Terms of Reference – Foreign Exchange Allocation and Access by Businesses Operating in Ethiopia

Overview

After the Asian financial crisis in the 1990s, many African emerging economies learned the painful lesson of the importance of maintaining a surplus balance to protect their country from volatile capital flows. Studies have shown that large foreign exchange (forex) reserves helped some Asian countries perform better than developed ones during the more recent global financial crisis in 2008. Like many emerging African economies, Ethiopia aspires to replicate the stability of Asian economies by increasing its foreign currency reserves under a fixed exchange rate system. Foreign reserves have accumulated at a much faster pace in emerging economies than developed countries, because many are either national resource rich countries or have a strong export-oriented manufacturing industry.

However, export revenues were largely unchanged despite significant volume growth, as global agricultural commodity prices remained low. Foreign direct investment (FDI) growth was 27.6% due to investments in new industrial parks and privatisation inflows. International reserves at end-2016/17 stood at US$3.2 billion (just under 2 months of prospective imports cover). In October 2017, the National Bank of Ethiopia (NBE) devalued the birr by 15% relative to the U.S. dollar, thereby reducing overvaluation and enhancing competitiveness. Simultaneously, the NBE increased interest rates and adopted a restrictive stance to minimise the adverse effects on inflation which was running at 13.6% in November 2017. Since October 2016, the Ministry of Finance and Economic Cooperation (MOFEC) has implemented further cuts in external borrowing by state owned enterprises (SOEs) and has reduced outstanding non-concessional commercial debt. The authorities' policies envisaged under the GTP II are expected to underpin domestic private sector development and FDI. The GTP II also envisages allocating significant resources to poverty alleviation and the social safety net, while efforts to strengthen financial inclusion are underway. Growth has brought certain economic challenges for policy setters and decision makers. One of these challenges is a rapid increase in demand for imported goods and services that are not being matched with parallel increases in export revenue. This, coupled with many other trade-related constraints, is seriously challenging the competitiveness of Ethiopian businesses including those engaged in the export and manufacturing sectors.

The ever-growing import bill and stagnant export revenue has led to an acute shortage in forex and the private sector has become the primary victim. As a result, it is estimated that businesses, especially those not engaged in exporting, have to wait between 6 – 9 months to receive approval on their import applications. This, added to the inefficient inbound logistics of transporting goods from abroad, makes these businesses uncompetitive, which has caused administrative challenges including rent-seeking practices, which has further increased transactions costs and lack of competitiveness.

Selected development partners have come together to analyse the forex problem with the aim of finding a solution to increase the competitiveness of the private sector operating in Ethiopia. Enterprise Partners (EP) is coordinating the working group as part of its objective of working on and addressing binding constraints to a competitive Ethiopian private sector. As part of its work, EP has requested support from BERF in conducting a detailed review of the current policies, administration practices and challenges in accessing foreign exchange by businesses and how this is affecting their competitiveness.

Objectives

The main objective of this assignment is to conduct a detailed review of the current policies, administration practices and challenges in accessing foreign exchange by businesses operating in Ethiopia and how this is affecting their competitiveness.

Link between BE Constraints, BE Reforms and Poverty Reduction

The assignment links directly to improving the business environment in Ethiopia, benefitting businesses and thereby resulting indirectly in poverty reduction.

Client and Beneficiaries

The client for this assignment is DFID Ethiopia. The main beneficiary is Enterprise Partners (EP). Other potential beneficiaries are ministries, departments and agencies (MDAs), private sector business membership organisations (BMOs), civil society organisations (CSOs), Ethiopian MSMEs and the poor.

The Consultant will coordinate the assignment workplan and liaise closely with the Technical Director of Enterprise Partners. The Development Partners' Working Group on Forex will oversee and provide input on the draft report.

This assignment provides expert external assistance and does not replace the work of DFID civil servants.

Scope

The scope of the assignment is broadly limited by the DCED definition of the business environment: "a complex of policy, legal, institutional, and regulatory conditions that govern business activities. It is a sub-set of the investment climate and includes the administration and enforcement mechanisms established to implement government policy, as well as the institutional arrangements that influence the way key actors operate (e.g. government agencies, regulatory authorities, and business membership organisations including businesswomen associations, civil society organisations, trade unions, etc)."

In conducting this review, the Consultant will:

- Review all the governing policies, proclamation, directives and circulars on the Ethiopian foreign exchange and forex reserve system. Highlight potential perverse outcomes of the current regulation (some companies benefit massively). Identify the winners and losers of any proposed changes;
- Review the amounts of incoming hard currency over time and its allocation (government, banks, private sector, etc.);
- Estimate the size of parallel market, key beneficiaries and ways to curtail it;
- Assess the system and procedures for receiving and allocating forex inflows to commercial banks from various sources including export, remittances, FDI, etc.;
- Review past and current procedures and practices in foreign currency application and access by businesses operating in Ethiopia engaged in different sectors (manufacturing, service, export, state-owned, ones in Industrial Parks);
- Assess current practices and procedures by commercial banks in allocating foreign currency to businesses (both by private and state owned commercial banks);
- Analyse the impact of various recently introduced policies and directives (have they impacted positively or not on the forex allocation process to businesses?);
- Analyse the business and financial cycle of selected businesses and the impact of delay in accessing forex on the overall performance and competitiveness of these businesses;
- Conduct in-depth review of foreign currency retention and diaspora account privileges;
- Undertake a comparative study on forex policy regimes in other countries, focusing in particular on those with heavily involved governments;
- Provide recommendations on the possible courses of action that Ethiopia could follow to solve the problem of forex constraints, particularly in the short run and focussed specifically on forex rather than broader private sector competitiveness issues, with the aim of increasing the competitiveness of the private sector;
- Provide an estimate of the timeframe in which the current strategy of export-led growth to address forex constraints can address the issue, based on the current trajectory of export growth;
- The review should include reference to the following cross-cutting issues: gender and youth.

Method

- **Desk research:** desk review of policies, proclamations, directives and circulars and other relevant documents to be provided by DFID/EP.
- **Country visit:** Interviews with key stakeholders (commercial banks, businesses, national bank of Ethiopia, etc.).
- **Country presentation.** Presentation to DFID/EP and other relevant organisations of preliminary findings and conclusions.
- **Case study:** on at least one representative business (engaged in manufacturing, services, export, state-owned, or Industrial Parks).

- Report drafting: Final report, including recommendations on reforms necessary to address the situation.

Timeframe

The assignment is expected to be completed in 47 consulting days. The final report is to be submitted within 3 months from the assignment's commencement day.

Deliverables

Delivery Plan: including proposed timeline and anticipated stakeholder meetings, as set out in the BERF Consultant Briefing Pack. It should also include proposed revisions to these ToRs, reflecting discussions with DFID/EP during the kick-off meeting; such revisions to be reviewed and approved by DFID/EP.

Country Visit Report: based on the Delivery Plan, including brief summary of stakeholder meetings held, summary of presentation of preliminary results and proposed report outline, as set out in the BERF Consultant Briefing Pack (to be delivered to BERF team only).

Draft and final reports: (maximum 30 pages in length, excluding appendices) on the forex regime and practices of Ethiopia. The report should include an annex of a case study on selected businesses, and a summary of forex governing rules and regulations.

All reports will be produced in the BERF report template in accordance with the BERF Style Guide. The Draft Report will be submitted by the consultants to BERF for review and quality assurance (QA), and consultants will address the BERF comments. BERF will then submit the Draft Report to DFID/EP for review. Consultants will address DFID/EP comments and the Report will be submitted in final form by BERF to DFID/EP.

Contact us

Kru Desai

Government and Infrastructure

T +44 (0) 20 73115705

E kru.desai@kpmg.co.uk

Kongkona Sarma

DAI Technical Services

T +44 (0) 207 420 8600

E kongkona_sarma@dai.com

Peter Wilson

BERF Team Leader

T +44 (0)7850329362

E peter.wilson@kpmg.co.uk

www.kpmg.com

Department for International Development