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COLLEGE OF LAW AND GOVERNANCE STUDIES

SCHOOL OF LAW

GRADUATES PROGRAM

REGULATING THE FOREIGN EXCHANGE MARKET IN ETHIOPIA: THE CHALLENGES
AND NEXT REFORM AREAS

By: Gutu Hika

May 2023

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A Thesis Submitted In Partial Fulfilment of the Requirement for Degree of Master of Laws
(LL.M) In Business Law

By: Gutu Hika

Advisor: Solomon Abay (PH.D), Associate Professor

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ADDIS ABABA UNIVERSITY
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(Approval Sheet)

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Approved by

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Declaration

I, Gutu Hika, declare that the thesis is my own original work. The thesis has not been submitted for a degree in any other University and all materials employed in the thesis have been dully acknowledged.

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ABSTRACT

Many important aspects of foreign exchange market organization are affected by regulations. Thus regulations are an integral part of the organization or infrastructure of foreign exchange markets. They typically place limits on the use and allocation of foreign and domestic currencies, operations by intermediaries, the types and characteristics of contracts, and trading locations. They can significantly alter exchange rate dynamics by circumscribing how individuals and institutions interact in the market.

Regulation of the foreign exchange market plays a significant role in macroeconomic development. It secures the stability of financial operations so long as properly formulated and adaptable to the changing circumstances of today's economic integration. Foreign exchange market regulation becomes an economic policy concern for both developing and developed countries. Of its contribution to economic development in the general and financial market in particular government pays considerable attention to the area.

This work studies the regulation of the foreign exchange market in Ethiopia. In doing so, it assesses the existing regulatory framework governing the foreign exchange market. It examines whether existing regulatory laws cause challenges to the market and points out the necessary next reform areas if needed. The study was conducted based on legislative analysis. The finding of the study shows that there are different challenges out there that hinder the regulation of the foreign exchange market. It also shows that further regulation of required for the inadequacy of the existing regulation in covering some areas. Finally, this work provides some recommendations which the writer considers appropriate.

Key words: *Foreign exchange market, Regulation*

Acronym

BIS	Banks for International Settlement
CAD	Cash against Document
CB	Commercial Bank
EMP	Exchange market pressure
EPRDF	Ethiopian people's Republic Democratic Front
FDI	Foreign Direct Investment
FX	Foreign Exchange
FXD	Foreign Exchange Directive
GATS	General Agreement on Trade and Services
IP	Industrial Park
IMF	International Monetary Fund
LC	Letter of Credit
MP	Monetary policy
MCP	Multiple Currency Practice
NBE	National Bank of Ethiopia
WTO	World Trade Organization
USD	United states Dollar
WB	World Bank

CHAPTER 1

1. Introduction

1.1 Background of the study

Ethiopian foreign exchange regime reflects the economic setting, size of the economy, and the economic policy of different governments that used to be in power. Thus, the foreign exchange market has experienced gradual changes and measures over six decades starting from the establishment of the National Bank of Ethiopia.

During Hailesillasié the size of the economy remained very small and a capitalist economic system was operating. Thus, the foreign exchange regime was designed to serve a small open economy and the simple managed foreign exchange regime stayed very static and unchanged for many years.

Later on, with the change in government in 1974 that adopted a command economic management, the fixed foreign exchange regime was continued and made to suit the pursued economic philosophy of the socialist military government where foreign exchange, like any other resource in a socialist economy, was channeled and directed to the various economic uses through an administrative mechanism. To control the utilization and allocation of foreign exchange resources of the country the then government issued a foreign exchange control regulation in 1977, which remained in force up to 1991.

The post-1991 government of the Country formulated a market-oriented economic system of management, the foreign exchange regime of the country over the past years has been liberalized in gradual steps in line with successive economic and external sector reform measures.

The landmark reform has been undertaken as part of liberalization through transferring the micro-management and operation of the foreign exchange market from NBE to Commercial Banks, via Directives. A different measure of foreign exchange market liberalization has been introduced then, throughout 2018.

Ethiopia has been undertaking home-grown reform agenda as part of its economic policy since 2019. Accordingly, different regulatory measures for further liberalization of the forex market have been passed. The privatization measures, reformulating investment laws to increase FDI capital inflow, the opening of Banking Sectors to foreigners, and incentivizing Ethiopians in the

diaspora to participate in the market, etc. Regardless of those measures contributing to the forex market to correct the country's FX imbalances, the liberalization measures through issuing regulations are not full-fledged.

The financial and monetary policies were designed following the newly formulated economic reform agenda. The role of the market is believed to be essential in poverty reduction and economic growth. Therefore, the government takes significant measures of financial liberalization and monetary adjustment which fits and conforms to a market-led economy. We are witnessing positive steps on the part of government for the financial market liberalization in general and the foreign exchange market in particular.

The very purpose of this research is not on the importance of regulation, it is to examine the regulatory aspects of the Ethiopian foreign exchange market and try to identify what kind of challenges brought about by regulation against forex under the existing regulation, study in depth the potential challenges face government. See if there is any improvement made by surveying what regulation of forex looks like under foreign jurisdiction and existing best practices to come up with the results of recommending the next reform areas necessary to fit the country's Forex market and the current 'homegrown reform agenda' economic policy on going.

1.2 Statement of the Problem and Research Questions

Ethiopian foreign exchange market regulation has been an issue of controversy attracting the business community's attention, regulatory body, FDI, and all market participants after the policy of 'homegrown reform agenda' was designed, in 2019. Among others, correcting FX imbalances is one essential economic reform agenda within the scheme of the overall policy. Demand and supply of FX remain imbalanced, and weakness in balance of payment, inadequate international reserve, and high exposure to external debt reported although four years have gone since the policy of homegrown reform agenda was introduced.

Most of the regulatory liberalization measures taken by the government are evident as if the government pays considerable attention to capital inflow. Moreover, the global crisis of COVID-19, political instability, and the unstable attitude of Ethiopians in the diaspora towards government economic policy add a headache to the FX market. Furthermore, the role of FDI in the capital market remained restricted, particularly in portfolio investment. The rules in

investment law as to registration, license, and repatriation continued to be controversial. The exchange rate pressures and the parallel (black) market continue to be challenging.

The researcher identifies that no further study conducted with a particular focus on the ‘Regulation of foreign exchange market of Ethiopia’.

The researcher found a study conducted by Solomon Abay (Dr), which pointed out the existence of a parallel market and recommends for recognition and regulation. It stated as follows “There is also informal foreign currency exchange market in the country which is often known as black or parallel market and whose exact size is not known. The country needs to formalize and regulate it to avoid market distortion.”¹ Whereas the overall study is not specific to the foreign exchange market, rather it focuses on the general development, policy, and regulation of the financial market in Ethiopia.

The study conducted by Abebe Deresa (2006) analyzed the Exchange Market Pressure and Monetary Policy in Ethiopia, this is not the issue of overall regulation addressed.

Considering the importance of the area and the absence of further study conducted, the researcher decides to research to find and analyze the legal framework of Ethiopian foreign exchange regulation, challenge, and next reform areas. Hence, a question of further liberalization and setting of proactive forex market regulatory measures (reform) will be addressed.

Accordingly, the research questions are:

1. What does the existing Ethiopian foreign exchange market regulation look like?
2. What are the challenges of Ethiopian foreign exchange market regulation?
3. What would be the next reform areas in the foreign exchange market regulation? If any.

1.3 Literature review

Foreign exchange market regulation was and is in operation dating back to 1942. Whereas, unlike the issue of another financial market much has not been said and written as to the foreign exchange market of Ethiopia. Particularly, either negligently or intentionally left aside by legal

¹ Abay Yimer, S. (2011). Financial market development, policy, and regulation: the international experience and Ethiopia’s need for further reform.

scholars of the country. A researcher says so for the absence of literature on the area assisting the study of the regulation of the foreign exchange market. There are only a limited number of reports by the IMF, a group of experts, magazines, and NBE periodic reports on the performance of the foreign exchange market of the country and it is not an analysis of the regulation of the foreign exchange market. Therefore, the researcher establishes that there is a gap in the area. Hence, taking advantage of the gap, this study is conducted as follows;

Examine the existing policy, proclamation, regulation, and directives of the foreign exchange market in the country, review of studies conducted on the area if any not only from law perspectives may be economics, use of data from government and Non-governmental reports including reports of NBE, Commercial banks, and Forex bureaus, The Ethiopian Investment Commission, Ministry of finance and economic development, Ethiopian press agency, Addis standard, business insider, etc. Last but not least field study of the foreign exchange market practices of the Country through interviews with concerned personnel. Finally, international sources like IMF reports and Articles of Agreement, BIS (Banks for International Settlement), WB (World Bank), GATS (General Agreement on Trade and Services), WTO (World Trade Organization), and G-20.

1.4 Objectives of the study

1.4.1 The general objective

The main objective of this study is to explore the regulation of the foreign exchange market in Ethiopia, identify the challenges associated with regulation, and thereby show the necessary next reform area.

1.3.2 Specific Objectives

The study has the following specific objectives:

- To examine the Ethiopian policy and regulatory framework of the foreign exchange market.
- To assess whether regulation of the foreign exchange market brings a positive response to correct FX imbalances.
- To identify the potential challenges of existing regulation of the foreign exchange market.

- To point out the necessary next reform area of Ethiopian foreign exchange market regulation.

1.5 Significance of the Study

The examination of the laws and the analysis to be made under this study is hoped would serve an academic purpose. It is also hoped that the study will inform policymakers and legislators and assist them in making decisions in relation to the regulation of the foreign exchange market and inform them of necessary reform areas in the future. At the same time, the research will point out areas that require further research as well, adding to the academic significance.

1.6 Scope of the Study

The study focuses on the regulation of the foreign exchange market in Ethiopia. Accordingly, the study analyses the policies on the foreign exchange market and laws (proclamation, regulations, directives, guidelines, Circulars) associated with governing of Ethiopian foreign exchange market. Hence, the focus will be only on the current regulatory framework, not on the laws repealed.

1.7 Methodology of the Study

To achieve the objective of the study the research will be conducted qualitatively. Because it is based on the investigation of what exists in the regulation regarding the forex market.² To this end review of published and unpublished materials, journals, and books will be made.

The other issue that needs to be answered is the best way question asked by the researcher is going to be attained. The answer to this in turn leads us to the research approach. The nature of the research problem, the aim of the research, and the nature of the research question that the research seeks to answer need a deep understanding of the issue. Besides, the research questions are only answered whenever there is interaction between the researcher and the area to be investigated. There is a need to explain concepts. And this is only done through a qualitative approach.³ Hence, for the reason mentioned above this research employed a qualitative approach

² Ian Dobinson and Francis Johns, *Qualitative Legal Research* in Mike McConville and Wing Hong Chui (eds.), Edinburgh University Press (2007), p.18

³ John W. Creswell, —*Research Design: Qualitative, Quantitative, and Mixed Approaches*“, 2nd ed., 1999, pp.205-9.

1.7.1 Population and Sampling

The researcher for the empirical aspect interviewed the concerned organ regarding the challenges of regulation. Accordingly, the NBE, Commercial Banks (government and private), will be the general population selected for this study. NBE is mandated with the formulation of laws regulating the foreign exchange market whereas other selected informants are directly or indirectly affected by the regulation.

The researcher used non-random/non-probability sampling. This method of sampling is selected because the research approach selected is a qualitative approach, which only goes with non-random sampling. Secondly, the research does not attempt to generalize what it gets from the sample. In addition, this is effective only by employing non-random sampling. Among non-random sampling techniques, the research employs purposive non-random sampling as it gives a researcher the freedom to consider needs in a research project. Besides, it enables the researcher to handpick subjects based on specific characteristics, which is visible from the issue of the study.

1.7.2 Types of Data

The research employs both primary and secondary data. With the doctrinal aspect, the primary data includes domestic laws (proclamations, regulations, directives), and international laws. It also used different policy and strategy documents. Secondary data books, articles, reports, and situational analyses are used. Coming to the empirical aspect, the researcher used the data gathered through semi-structured interviews as primary data.

1.7.3 Data Collection Method

The researcher employs interviews and analysis of documents and material as a qualitative data collection method. The research objectives that the research needs to attain and the nature of the research questions that the research is meant to answer are only addressed by employing the above data collection methods. The research needs interaction between the researcher and the research participants, which could be effective through interviews. Hence, there might be a need to give an explanation to the interviewees and modify the questions as per the backgrounds of the interviewees. Therefore, using a semi-structured interview in this research is imperative. A semi-

structured interview is flexible in the sense that it gives freedom to the researcher to modify questions and to give explanations for some questions.⁴

1.7.4 Data analysis

The researcher used a qualitative data analysis method. The research uses this method because the data are collected through qualitative data collection tools, hence, needs to be analyzed in the same way. Accordingly, the data collected will first be prepared before analysis and this involves transcribing interviews, typing up field notes, or sorting and arranging the data into different types. Then the next step is to categorize the relevant one to the research focus by identifying the main theme and then interpretation will follow. In this process, the researcher will code the data and categorize it into different themes, and then a conclusion will follow.

1.8 Reference and citation

As per the LLM Thesis Guideline of the School of Law of Addis Ababa University, the OSCOLA referencing style is used in the thesis. For domestic laws and data, I will follow the rules of citation of the Journal of Ethiopian Law.

⁴ Ibid

CHAPTER 2

2.1 Overview of Regulatory instruments affecting FX market organization

Many important aspects of foreign exchange market organization are affected by regulations. These regulations are an integral part of the organization or infrastructure of foreign exchange markets. They typically place limits on the use and allocation of foreign and domestic currencies, operations by intermediaries, the types and characteristics of contracts, and the trading locations. They can significantly alter exchange rate dynamics by circumscribing how individuals and institutions interact in the market, and may result in the segmentation of the market.⁵

2.1.1 Types of Regulation

A. Regulation of the Use of Foreign and Domestic Currencies

Regulations can affect customers' demand for and supply of foreign and domestic currencies among other things, by defining the monetary and other uses that residents and nonresidents can make of foreign exchange, and by defining the transactions that can legally be made with domestic currency. Surrender requirements are also common when residents are not allowed to hold foreign exchange or foreign currency-denominated assets as a store of value.⁶ Market segmentation may arise when the authorities try to influence the use of foreign exchange through regulation.⁷ For example, country authorities may require that foreign exchange used for international current and capital transactions be traded in separate markets at different rates. To facilitate enforcement, the authorities may impose different structures on the separate markets, for example, a centralized two sided auction scheme for current transactions and a decentralized multiple-dealer market for capital transactions.

B. Regulation of Intermediaries

The effective enforcement of foreign exchange regulations typically involves the regulation of intermediaries, who also often play an important role in upholding various types of market segmentation. The regulation of intermediaries may also serve an important prudential purpose.

Most developing and transition economies limit foreign exchange dealings to authorized institutions. Licensing of intermediaries in the foreign exchange market is common. Institutions

⁵ Canales-Kriljenko, J., forthcoming, "Foreign Exchange Market Organization in Selected Developing and Transition Economies: Results of a Survey," IMF Working Paper (Washington: International Monetary Fund).

⁶ Ibid

⁷ Multiple foreign exchange markets may, under certain conditions, give rise to multiple currency practices that are inconsistent with a country's obligations under Article VIII, Section 3.

eligible for licenses to deal in foreign exchange typically include banks and foreign exchange bureaus.⁸ Foreign exchange bureaus are typically allowed to deal in foreign currency cash and traveler's checks, but cannot deal in foreign exchange transfers or hold accounts abroad.

C. Regulation of Trading Locations

Foreign exchange regulations may determine the geographical location where the domestic currency can be traded in exchange for foreign currencies. These regulations may also reduce the likelihood that assets denominated in a particular currency will be included in a diversified worldwide portfolio. These regulations may include an outright prohibition of offshore domestic currency trading and restrictions on the export and import of domestic currencies. These measures are typically taken to close off avenues for speculative attacks. A few countries have allowed the trading of their currencies on well-known international exchanges.⁹

E. Regulation of Exchange rate

There is a systematic relationship between the use of certain types of foreign exchange regulations and the exchange rate regime. Specifically, some of the regulations discussed above were most prevalent in countries maintaining a conventional fixed peg to another currency or a basket of currencies. These include restrictions on payments to residents in foreign currencies, restrictions on the use of foreign currency as a store of value, restrictions on interbank dealing, and regulatory limits on forward contracts. Some of these regulations were also used extensively in countries that relied heavily on external financing. The use of these regulations appears to be intended to reduce the vulnerability of pegged regimes to speculative attack. The use of these regulations was far less common in countries with a currency board, possibly reflecting the higher degree of commitment to exchange rate stability and monetary discipline that this exchange rate regime requires.¹⁰

⁸Ibid

⁹ Ariyoshi, A., and others, 2000, *Capital Controls: Country Experiences with Their Use and Liberalization*, IMF Occasional Paper No. 190 (Washington: International Monetary Fund).

¹⁰ Canales-Kriljenko, J., forthcoming, "Foreign Exchange Market Organization in Selected Developing and Transition Economies: Results of a Survey," IMF Working Paper (Washington: International Monetary Fund).

2.2 Experience of Chinese Forex Market regulation

In mainland China, cross-border foreign exchange transactions are subject to foreign exchange controls and all foreign exchange derivative transactions are subject to certain substantive regulations.

In the Chinese foreign exchange system, all foreign exchange transactions involving a cross-border element are regulated¹¹ and classified into two categories: capital account items and current account items. As described more fully below, capital transactions are subject to strict capital controls which restrict the convertibility of the Chinese currency, RMB. As a result, RMB trades in the domestic Chinese market within central bank established exchange rate bands as well in an offshore market outside of China.

China's current foreign exchange control system was first introduced in 1996 but today the 2008 Foreign Exchange Administration Regulations are the primary source of regulation for the Chinese foreign exchange control system. The principal bodies responsible for regulating the foreign exchange market are the State Administration for Foreign Exchange ("SAFE") and the People's Bank of China ("PBOC"). SAFE is the administrative agency charged with overseeing foreign exchange activities in China including the issuance of relevant regulations. The Administrator of SAFE also serves as the Deputy Governor of the PBOC.

The approval of, or the filing of records with, SAFE is required for a range of transactions involving cross-border foreign exchange payments. SAFE has designated certain commercial banks to undertake settlement and exchange of foreign exchange transactions.¹² These designated banks may process permitted transactions without SAFE approval in accordance with the operating guidelines directed by SAFE from time to time.¹³ The PBOC is the central bank of

¹¹ Foreign Exchange Control Regulations of the People's Republic of China (promulgated by the St. Council, Jan. 29, 1996, amended Jan. 14, 1997, re-amended August 1, 2008, effective August 1, 2008), No. 532, chs. 2, 3 (China) http://www.fdi.gov.cn/1800000121_39_675_0_7.html. [hereinafter China FX Control Regulations].

¹² Provisional Regulations on the Management of Settlement, Sales, and Payment of Foreign Exchange (promulgated by the St. Council, Mar. 24, 1994, effective Apr. 1, 1994), ch. 1, art. 2 (China) <http://en.pkulaw.cn/display.aspx?cgid=954c230ca59e990bbdfb&lib=law>.

¹³ *Ibid.*, at ch. 3, art. 21.

China. One of its roles is to maintain and manage China's official foreign exchange reserves and maintain the RMB exchange rate.¹⁴

Capital account items are capital inflow or outflow transactions including the increase or decrease in a company's capital, foreign direct investment, loans, and securities investments.¹⁵ Capital account transactions commonly arise out of: (a) inbound investments by foreign investors and outbound investments by Chinese entities, (b) loans extended by foreigners to Chinese entities, and (c) cross-border guarantees. All capital account transactions are strictly controlled and are subject to approval by, or registration with, SAFE. In certain cases, in lieu of SAFE approval, transactions may be processed by, transactions may be designated banks pursuant to a filing and registration requirement established by various SAFE notices and circulars. Since 2011, SAFE has moved in a measured manner to relax the controls over certain types of capital transactions.

Current account items are ordinary recurring business transactions and commonly arise out of: (a) payments and receipts for the sale of goods, (b) the provision of services, (c) payments of royalty, license, franchise, and other intangible property transactions, (d) personal or real property lease transactions, and (e) dividends. Generally, no SAFE approval is required for current account transactions. Businesses can freely convert foreign exchange for current account transactions subject to any required government approval of the underlying transactions. These foreign exchange transactions can be processed by a SAFE designated bank which is required to review the authenticity of the underlying transaction documentation and the payment of all applicable Chinese taxes.¹⁶

On January 5, 2011, the CBRC further revised the 2004 Provisional Derivatives Rules by issuing the Administrative Rules on Derivative Transaction Business of Banking Financial Institutions

¹⁴ Law of the People's Republic of China on the People's Bank of China (amended by the Standing Comm. Nat'l People's Cong., Dec. 27, 2003) ch. 1, art. 4, § 5 (China), <http://www.npc.gov.cn/englishnpc/Law/2007-12/12/content-1383712.htm>.

¹⁵ Ibid

¹⁶ China's FX Control Regulations, supra note 15, at ch. 3, arts. 21-23.

(the "2011 Administrative Derivative Rules").¹⁷ The 2011 Administrative Derivative Rules "apply to derivative transactions entered into by a banking financial institution."¹⁸

Under the 2011 Administrative Derivative Rules, in OTC derivative transactions (including all FX derivative transactions) between a banking financial institution and clients, the banking institution is required to regularly provide clients, which are not financial institutions, with written valuation reports or risk reminder letters delivered by letter, e-mail, fax or any other recordable means, and ensure that the relevant materials are delivered to the client in a timely manner."¹⁹

In terms of implementing the G20 commitments, China has introduced mandatory trade execution and trade reporting requirements applicable to certain foreign exchange transactions and market participants. Where mandatory trade execution applies, Chinese incorporated financial institutions ("PRC FIs"), including Chinese branches, must execute in-scope transactions with other PRC FIs via the China Foreign Exchange Trade System & National Interbank Funding Centre. In scope transactions are:

(1) RMB-FX forward transactions between the members of the interbank RMB-FX forward market; (2) RMB-FX swap transactions between the members of the interbank RMB-FX swap market; (3) RMB-FX option transactions between the members of the interbank RMB-FX option market; and (4) RMB-FX currency swap transactions between the members of the interbank RMB-FX currency swap market (together, RMB FX Derivative Transactions).²⁰

2.3 Regulation of the Foreign exchange market under different regimes of Ethiopia

The country experienced different regimes with different systems of administration and economic policy starting from the time the Italian occupation of five years ended.²¹ As part of financial market regulation, the regulation of the foreign exchange was issued as of its first kind in 1942. The landmark for the regulation of the foreign exchange market and considering the

¹⁷ CATHERINE HUSTED, JANE JIANG, & YVONNE SIEW, ALLEN & OVERY, CBRC ISSUED THE LONG AWAITED REVISED DERIVATIVES RULES (Jan. 31, 2011), <http://www.allenoverly.com/publications/en-gb/Pages/CBRC-issued-the-long-awaited-revised-derivativesrules>. Art.3

¹⁸ Ibid

¹⁹ Memorandum from JunZeJun Law Offices for aosphere LLP (Oct. 17, 2018) (on file with aosphere LLP) [hereinafter JunZeJun]; G20 REGULATORY REQUIREMENTS RELATING TO DERIVATIVES TRANSACTIONS TN THE PEOPLE'S REPUBLIC OF CHINA: SUMMARY, AOSPHERE LLP (2018), aosphere Rule finder G20 [hereinafter G20 REGULATORY REQUIREMENTS].

²⁰ Ibid

²¹ This time new phases of modernizing financial institutions and markets started.

importance of the market established then.²² Following this time the development of foreign exchange market regulation and the liberalization process of the market continued to date. Accordingly, the regulation of the foreign exchange market is known for its dynamic modification and amendments following the change in government, economic policy and objectives, and monetary policy and objectives followed by the regulator.²³ As a result, there was and is a difference in a regulation adopted depends on the Regimes of the time. Hence, we can classify them as the era of Hailessillassie, Dergue, and EPRDF under this chapter.

2.3.1 Forex Market Regulation during Hailessillassie

Up to the early 70s, the size of the economy remained very small and the then government pursued a capitalist economic system, the country had a foreign exchange regime that was designed to serve the needs of a very small open economy and simply managed foreign exchange regime stayed very static and unaltered for many years.²⁴ This extended from early 1940s throughout '70s.

Ethiopia had heavy regulation of foreign exchange as of the beginning of its foreign exchange regime in 1942.²⁵ It started to control trade in foreign currency (and negotiable instruments denominated in foreign currency) by the Currency Proclamation No. 31 of 1942 and established its foreign exchange control system by the Currency (Amendment) Legal Notice No. 127 of 1949.²⁶ It dissolved the State Bank and transferred the functions to the National Bank of Ethiopia in 1963.²⁷ It controlled all transactions in foreign exchange and the use of foreign currency directly (through the NBE).

2.3.2 Forex Market Regulation during the Dergue Regime

The military government (Dergue) announced a command economy starting in 1974. Then the monetary policy was designed in general and the forex market was administratively decided to serve the interests of the government. Compared to the predecessors there were high regulatory

²² This period serves as a frame of reference for studying what Ethiopian foreign exchange market regulation looks like

²³ Ethiopia went through phases of change in government and economic policy adopted for 60 years. The capitalist, command economy, and the free market (market-oriented).

²⁴ Consolidated Ethiopian forex directives, <https://chilot.files.wordpress.com>, 2012.

²⁵ Abay Yimer, S. (2011). Financial market development, policy, and regulation: the international experience and Ethiopia's need for further reform, p.112.

²⁶ Ibid

²⁷ Ibid, IGE, 1963d; IGE, 1963e; and IGE, 1963f

laws issued focusing on forex market adjustment with increments in the size of the economy and volume of transactions.

The fixed foreign exchange regime was continued and made to suit the pursued economic philosophy of the socialist military government where foreign exchange, like any other resource in a socialist economy, was channeled and directed to the various economic uses through an administrative mechanism.²⁸ It issued several foreign exchange control rules (in forms of regulations, amendments, notices, and directives) as of 1977. The first comprehensive enactment was the Foreign Exchange Regulations- National Bank Of Ethiopia Notice No. 1/1977 (NBE, 1977), issued by the NBE on January 5, 1977, according to an authority vested in it by Article 61(3), 65, 67, and 73 of the Monetary and Banking Proclamation No. 99 of 1976 (PMGE, 1976i). The notice had full force until it was reformed under the Monetary and Banking Proclamation No. 83 of 1994.²⁹

The regulation continues to monopolize the NBE to regulate, monitor, and micro-management operations of the foreign exchange market. Moreover, commercial Banks are dependent on the NBE to get access to Foreign Currency and the Bank (NBE) furnishes foreign currency for the authorized bank to enable the operation of daily transactions.³⁰ This established that the only dealer in foreign exchange was the controlling authority (NBE) or no delegation for commercial banks to transact in foreign currency. Hence, there was no involvement of intermediaries of FX.

The surrendering requirement was stipulated and impossible for authorized banks to hold an excess foreign currency more than allowed to have by National Bank.³¹ Moreover, not more than 600,000 Br was allowed to be held and if hold it should be surrendered.³² Holding foreign currency was prohibited without prior authorization of the National Bank. Moreover, the acquisition of stocks, shares, and bonds in the form of investment abroad by authorized banks with foreign currency without authorization is impossible.

²⁸ Consolidated Ethiopian forex directives, <https://chilot.files.wordpress.com> 2012.

²⁹ Abay Yimer, footnotes 685.

³⁰ Foreign Exchange Control Regulation Issued In 1977, Notice 1, Art. 3

³¹ Ibid, Art.4/1

³² Ibid, Art.4/2

Foreign exchange market rate was used to be fixed or fixed form exchange rate decided by the National Ban was in operation.³³ Accordingly, the exchange authority was the autonomous price maker regardless of market participants or exact actual exchange rate. Hence, there was no bargain as to the price between the authorized bank and NBE on buying and selling, the rate was fixed in advance.³⁴

The daily status of authorized banks' exposure to FX through their account should be reported to the National Bank of Ethiopia. This includes reporting letters of credit, forwards, and guarantees to correspondent banks abroad, of commitments undertaken by authorized commercial banks.³⁵

A type of contract involving foreign currency was identified and direction forwarded by the NBE. Hence, a loan or guarantee agreement with banks abroad was impossible without prior approval by NBE,³⁶ to forward exchange transactions the agreement was made only to cover commitments and approved in advance.³⁷ Moreover, a sales contract having acceptance must be with a limited period or immediate shipment not exceed 90 days.

Exporting of goods by the natural or juridical person was prohibited unless the NBE authorizes and the exporter undertakes to surrender the resultant sales proceeds in foreign exchange to an authorized bank.³⁸ Here the involvement of the authorized bank in the process of export is minimal or limited to taking over of sales proceeds from the exporter.

Trading location was strictly regulated and exporting of goods to the limited destination was prohibited. Hence, exporters were prohibited to export to the Republic of South Africa and Rhodesia.³⁹ This has policy implications.⁴⁰

There was a stringent requirement regarding repatriation. Registration and license was prerequisite for repatriation by the foreign investor. Registration in question must be up on the

³³ Ibid, Art.7/1

³⁴ Ibid, sub.4 and 5

³⁵ Ibid, Art.8

³⁶ Ibid, Art.4/6

³⁷ Ibid, sub.7

³⁸ Ibid, Art.19

³⁹ Ibid, Art.32

⁴⁰ During this time (1977) Apartheid system was operating in South Africa. Thus Ethiopian government was highly committed to liberation and stood against Apartheid then.

initial entrance. Even if they were registered and had secure licenses, permission for remittance was not absolute. An amount to be remitted annually was fixed to 40000 birr only.⁴¹

Holding of foreign exchange was allowed for travelers abroad upon the condition, these include travel for government work, medical, education, vacation, business, etc., provided that the travelers surrender all the foreign exchange held upon coming back home (arrival). Moreover, the authority imposes a criminal sanction on a resident found holding foreign currency under his/her possession and the money shall be confiscated.⁴² Foreign currency account was allowed with limitation and not fully liberalized. In general, the regulation was followed by a plethora of amendments in the form of notices.

2.3.3 Foreign Exchange Market regulations during EPRDF

The post-1991 change of government in Ethiopia brought about social, political, and economic transformation. The market-oriented economy of the free market was the economic policy adopted. The role of the government was limited to the facilitation of the working environment through regulating, monitoring, and supervising. Moreover, the privatization of the previously public-owned enterprises was undertaken. Furthermore, financial market liberalization was considered critical in the economic growth of the country.

As part of foreign exchange market liberalization foreign exchange regulations fully liberalize current account international payments for various purposes by issuance of Directive No. FXD/07/1998.⁴³ Moreover, the overall operations and micro-management of forex transactions, selling and buying in forex currency, and processing import and export as per the directive were transferred to commercial Banks.⁴⁴ Therefore, commercial banks held the role of intermediary in forex transactions. Hence, the forex bureau was established as a seller and buyer of foreign currency within the commercial banks. Consequently, the NBE assumes the role of supervising and monitoring the commercial banks for the proper implementation of directives.

Accordingly, the regulations allow payments for all imports of goods, except goods that are believed to be detrimental to the health of the public and the security of the nation. Payments for imports can be made by letter of credit, cash against documents, advance payment, etc. Imports

⁴¹Foreign Exchange Control Regulation Issued In 1977, Notice 1, Art. 33, 34, and 35.

⁴²Ibid, Art.47/2.

⁴³ Directive to Transfer NBE's Foreign Exchange Functions to Commercial Banks Directive No. FXD/07/1998

⁴⁴ Ibid

of second-hand or used goods are also allowed, more specifically various used vehicles, machinery, and equipment, in which foreign exchange is availed to these items with their service year after manufacture and the original FOB price.⁴⁵

Similarly, exports of goods and services are allowed through letters of credit, cash against documents, advance payment, consignment, etc.,⁴⁶ and payments for services associated with these exports are also permitted. Small items of limited value and quantity are also allowed to be exported without foreign exchange repatriation requirements.⁴⁷

To encourage and support the export sector, the foreign exchange regime allows exporters to open a retention account to hold a specified amount of their export earnings for a defined period and use their forex holdings for their export business promotion. A credit guarantee scheme is also made available to exporters to back the export sector.⁴⁸

Non-resident Ethiopians and non-resident foreign nationals of Ethiopian origin are permitted to open a foreign currency account at any authorized commercial bank in four major international currencies with a limited amount that shall be deposited in the current account. The deposits shall earn interest based on the arrangements made with commercial banks. On the other hand, no Ethiopian national resident in Ethiopia or resident Ethiopian company is allowed to maintain a bank account abroad without the National Bank of Ethiopia's authorization. But, government offices, organizations, and companies that have branches or offices abroad and which are permitted by a competent authority to operate these offices abroad are admitted to open the account they deem necessary. On winding up the business, they are, however, required to close the account and report to the National Bank of Ethiopia.⁴⁹

Any capital inflow by foreign investors is recognized and registered at the National Bank of Ethiopia at the initial stage of investment, including investments made through a concessionary or a partnership agreement with the government or with an autonomous institution, and similar treatment is accorded to plowed back profits.⁵⁰

⁴⁵ Ibid

⁴⁶ Ibid, Art.6/3

⁴⁷ Ibid, Art.6/9

⁴⁸ Supra note 27, 2.13

⁴⁹ Ibid, 2.15

⁵⁰ Ibid, 2.18

Capital gain on asset revaluation of a business enterprise may be repatriated by fulfilling the requirements. Loan and supplier credit obtained by foreign investors are registered as capital inflows by the National Bank of Ethiopia. Foreign investors who earn profits or dividends from recognized investments and services are allowed to remit abroad by presenting the required documents or statements.⁵¹ Therefore, we can infer that the current account for foreign currency was liberalized.

To the effect of monitoring and supervision, registration, and license was a condition to engage in forex transactions for prudential purpose. Reporting and furnishing all necessary information concerning forex exposure status were obligatory on the part of commercial banks. This contributes to the systemic stability of forex market transactions.

In addition, firms, companies, and business entities engaged in manufacturing or business activity whose products are sold to external markets generating foreign exchange income were allowed to have access to external financing and suppliers' credit from abroad to finance imports of input or auxiliary materials essential for their export product.⁵²

Subsequently, there were a lot of directives, circulars, and notices issued by the NBE to modify, amend and implement the existing regulation on forex transactions. The government restricts investment in financial sectors in the general and foreign exchange market in particular to Ethiopian nationals arguing for the underdevelopment of the market and the inability of local financial market organs to compete with that of foreign countries.

⁵¹ Ibid, 2.19

⁵² Ibid, 2.20

CHAPTER 3

3. Regulation of Ethiopian foreign exchange market currently: The challenges and the next reform areas

3.1 Overview of the Ethiopian Legal Framework on Regulation of foreign exchange market

The foreign exchange regime of the country, reflects the economic setting, the economic management system, the economic policy of the different governments in power, the structure and level of the economic development of the country, the performance of the external trade sector, and balance of payments position of the economy, etc. have experienced gradual changes and openness over the past 6 decades.⁵³ Up to the early '70s, the size of the economy remaining very small and the then government pursuing a capitalist economic system, the country had a foreign exchange regime that was designed to serve the needs of a very small open economy and the simply managed foreign exchange regime stayed very static and unaltered for many years.⁵⁴

But later with the change in government in 1974 that adopted a command economic management, the fixed foreign exchange regime was continued and made to suit the pursued economic philosophy of the socialist military government where foreign exchange, like any other resource in a socialist economy, was channeled and directed to the various economic uses through an administrative mechanism.⁵⁵ And to effect control on the allocation and utilization of the foreign exchange resource of the country, the then government issued a foreign exchange control regulation in 1977, which remained in force up to 1991. After the demise of this government and the advent of the EPRDF government, which by adopting a non-regulated economic system following market-oriented economic management, the foreign exchange regime, over the past fourteen years, has been liberalized in gradual steps in line with the successive economic and external sector reform measures. As a result, numerous foreign exchange transaction liberalization steps have been undertaken in the foreign exchange regime of the country, albeit on a piecemeal basis, which has necessitated the need to the study regulation of forex under this government.

More importantly, as significant parts of the micromanagement and operations function of foreign exchange transactions have been transferred from the National Bank of Ethiopia to

⁵³ Consolidated Ethiopian forex directives, <https://chilot.files.wordpress.com>, 2012.

⁵⁴ Ibid

⁵⁵ Ibid

commercial banks via directive No/FXD/07/1998 issued on August 31, 1998, it ushered intermediaries, Commercial Banks to the operation of forex transaction.

Central bank of the country, the National Bank of Ethiopia (NBE) is entrusted with the responsibility of maintaining the stability of the exchange rate of the Birr, the country's legal tender currency against other currencies.⁵⁶ Accordingly, during the 1970s and 1980s, when the Ethiopian Birr was pegged to the US dollar at a fixed rate, the NBE used to maintain exchange rate stability of the Birr by making available foreign currency to the market at the fixed rate.⁵⁷

Following the introduction of the auction system on May 1, 1993, and the subsequent replacement of the auction system by the daily interbank foreign exchange market in October 2001, demand and supply factors were given more latitude in the determination of the exchange rate. As a result, the NBE acts as a buffer between forces of demand and supply through intervention. Indeed, the NBE has attempted to stabilize the exchange rate through official interventions mainly by varying the amount of foreign exchange it supplied to the market. In effect, pressures in the foreign exchange market are reflected by changes in both the exchange rate and reserve holdings of the NBE.⁵⁸ The objectives of monetary policy in Ethiopia are, among others, maintenance of price and exchange rate stability and ensuring the safety and soundness of the financial system, within the broader macroeconomic policy of attaining a high level of economic growth. The responsibility for formulation and implementation of monetary policy in Ethiopia is vested in the National Bank of Ethiopia (NBE).⁵⁹

3.2 Ethiopian foreign exchange policy, proclamation and directives

The HPR is mandated with enacting laws on the administration of foreign exchange.⁶⁰ The house further delegates its mandates to the NBE in order to monitor, supervise, and regulate the operation of the foreign exchange market inclusive of monetary system operation. Moreover, foreign exchange transaction is subject to banking business activity.⁶¹ Therefore, when the banking business is regulated and determined as per the NBE directions, forex transactions are

⁵⁶Abebe Deressa, Exchange Market Pressure and Monetary Policy in Ethiopia, NBE

⁵⁷Ibid

⁵⁸Ibid

⁵⁹Ibid

⁶⁰ FDRE Constitution, Art. 55/10.

⁶¹Banking Business Proclamation No. 592/2008, Article 2/2/c.

subjected to NBE too.⁶² We can infer this from different directives issued at different times by NBE in order to manage foreign currency transactions. Accordingly, we can say that the regulation of foreign exchange is entrusted to the NBE. There are different instruments of regulation intended for FX market. Among others;

3.2.1 Forex Policy

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 that 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).

3.2.2 Forex 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 authorized dealers;
- 2) Imposition of terms, conditions, and limitations under which residents and non-residents can possess and utilize 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 liberalized only very gradually.⁶³

⁶²Ibid, Article 2/1.

⁶³ James Lloyd and Bisrat Teshome, Foreign Exchange Allocation and Access for Businesses in Ethiopia, and Business Environment and Reform Facility October 2018.

3.3 Exchange measures widely practiced by NBE: Regulation

3.3.1 Regulation of exchange rate

“The level and movements in the exchange rate have been a matter of policy concern for central banks of most countries, including that of Ethiopia, as erratic changes in the exchange rate not only undermine the goal of price stability but also reduce real output, trade, capital flows, and investment” (IMF, 1984). These considerations often prompt central banks to intervene in the foreign exchange market to influence exchange rate developments.⁶⁴

The NBE issued the directive regulating the daily foreign exchange cash notes and Transaction rate Directive No. FXD/43/2014. By regulation, the daily exchange rate and cash notes were determined. After 5 years of its operation the NBE amended its directives with the objective of fixation of daily foreign exchange buying and selling rates to create a clear computation among banks.⁶⁵ The foreign exchange daily rate for both cash and transaction was fixed by this directive.⁶⁶ Accordingly, the foreign exchange buying rate of a bank shall be the NBE interbank foreign exchange market indicative buying rate of the day.⁶⁷ In addition, the margin set between the buying and selling rate of the bank shall not exceed 2% (two percent) from NBE interbank foreign exchange market indicative buying rate of the day.⁶⁸ As well the daily buying and selling rate shall be posted in a publicly visible place and bank shall use the posted rate throughout the day.⁶⁹ Finally, it gives discretion for the bank, to buy foreign exchange from the retention account holder at negotiable rate not exceeding its selling rate of the day.⁷⁰ From this we can infer that the kind of exchange rate adopted by NBE is managed float exchange rate system based on interbank exchange rates daily.

From the aforementioned provisions of the directive, one can infer that the NBE determines the daily buying and selling rate of foreign currency within which the Bank needs to transact. In a sense that the market is driven not by participants, but rather driven by regulatory bodies. The market participant’s role is evident only in buying from the retention account holder where the Bank is authorized to buy at its selling rate of the day. Even here the reference to buying rate is

⁶⁴ Abebe Deressa, *supra* note 40.

⁶⁵ Fixation of the Daily Foreign Exchange Cash Notes and Transaction Rate (as Amended) Directive No. FXD/60/2018, Preamble.

⁶⁶ *Ibid*, art 3

⁶⁷ *Ibid*, art 3/1

⁶⁸ *Ibid*, art 3/2

⁶⁹ *Ibid*, art 3/3

⁷⁰ *Ibid*, art 3/4

to the selling rate of that very day, which has already fixed not to exceed 2 % from the buying rate.⁷¹ In conclusion, the autonomy of NBE in regulating the foreign exchange rate is high as per the directive. This seen as a penalizing business activity through the measures of imposing prices and avoiding competition among Banks based on market demand business community.⁷²

The NBE provides for the compliance measure to enforce the directive. Hence, stipulate a kind of civil sanction on non-compliance with authority requirements. Therefore, any bank that fails to comply with the requirements of any provision of this directive by any means shall be subject to a fine of Birr 10,000(Ten Thousand Birr) for each violation.⁷³

3.3.2 Regulation of foreign and domestic currency use

The NBE regulates the way through which both domestic and foreign currency needs to be used in the territory of Ethiopia and outside of Ethiopia as a means of implementing monetary policies. To this end, there are different directives issued and stipulates how residents, non-residents national, and foreigner holds currencies both domestic and foreign. The NBE directive NO.FXD/81/2022 provides for limits on Birr and Foreign Currency holding in the territory of Ethiopia. Mainly the objective of this directive is that limit the birr holding amount for the person entering and departing from Ethiopia and set the conditions, limitations, and circumstances under which an Ethiopian, resident of Ethiopia and non-resident or any other person who may possess and utilize foreign currency.⁷⁴ Regarding holding of birr, a person entering in to or depart from Ethiopia may hold up to a maximum of birr 3000 per travel to and from Ethiopia. Under exceptional circumstances, only a person traveling to Djibouti may hold up to a maximum amount of birr 10,000.⁷⁵ Moreover, concerning foreign currency holding residents and non-residents of Ethiopian origin are treated differently. Accordingly, a resident Ethiopian entering into Ethiopian territory carrying foreign currency shall convert all foreign currency at an authorized forex bureau for an equivalent sum in birr or deposit to his/her foreign currency saving account within 30 days from the date of entry stamped on the travel document by the immigration and citizenship service. However, s/he has to present a customs declaration if the foreign currency amount exceeds USD 4000. Whereas a foreign national of Ethiopian

⁷¹ Ibid, art. 3/2

⁷² Interview with Ato Birhanu Lami, Oromia International Bank S.C, Senior International Trade Service Officer, 17 April 2023.

⁷³ Directive No. FXD/60/2018, Art.4/1

⁷⁴ Limits on Birr and foreign currency holding in the territory of Ethiopia the NBE Directive NO.FXD/81/2022.

⁷⁵ Ibid, Art.3/1 and 2

origin and non-resident Ethiopian who enters Ethiopia carrying foreign currency and intends to stay for more than 90 days, shall deposit such a foreign currency into his/her non-resident foreign currency account, his /her foreign exchange saving account within 90 days from the date of entry stamp on the travel document by the immigration and citizenship service. The custom declaration is required for an amount exceeding 4000 USD.⁷⁶

A foreigner not residing in Ethiopia who enters Ethiopia carrying foreign currency may hold it in his/her possession up to the visa validity period. Here the reference for the legality of possession is limited by visa validity, once the validity of the visa is over, possession becomes illegal for the foreigner holding foreign currency. The legal way of possessing foreign currency by resident Ethiopian is through purchasing from banks with a limited period of 30 days for holding upon bank advice and once 30 days elapse s/he has to convert it to the equivalent amount in birr authorized forex bureau.⁷⁷

This directive provides also a requirement for traveling abroad holding foreign currency, as such presenting bank advice is mandatory showing the purchase of foreign currency from a bank within 30 days from departure for residents and foreign nationals of Ethiopian origin and nonresident Ethiopian.

3.3.2.1 Types of foreign currency account

Alike a domestic currency account opened in a bank by an individual in Ethiopia, the NBE regulates the manner, persons, and types of foreign currency accounts that are permitted to be opened and held by an individual. Therefore, we can find different types of accounts and persons to whom foreign account holding is allowed in different directives. Thus, retention accounts, non-resident current accounts (Diaspora), and employee current accounts (IP) are possible.

3.3.2.2 Retention account

Opening of foreign currency retention account is allowed for exporters of goods, services, and recipients of inward remittances.⁷⁸ This has the objective of incentivizing foreign currency-generating exports and services as well as encouraging and supporting the import substitution program of the government. Moreover, the retention account holder can use the amount of FX in

⁷⁶ Ibid, Art.4/1 and 2

⁷⁷ Ibid, Art. 4/3 and 4

⁷⁸ Utilization and Retention Directives article 3.

her/his account without restriction for importing goods and services for which prior authorization has been given already (license).⁷⁹

3.3.2.2 Non-resident account/diaspora account

Non-resident accounts were largely intended to be used by the diaspora to save their money in their home country. The beneficiary of this account is a non-resident Ethiopian national and non-resident of Ethiopian origin. It contributes to the ease of balances of payments problems and support international foreign exchange reserve. Moreover, helpful in attracting foreign direct investment.⁸⁰ This account can be used to make payments to importing items as per the directive of the NBE pre-proposed priority sectors, food items if an account holder is licensed, payment for services, make transfer abroad, withdrawal for travel allowance presenting valid travel document. Interestingly, it can serve as a collateral or guarantee for loans and repatriation abroad be allowed on request.⁸¹

3.3.3 Regulation of intermediaries

Like in many jurisdictions, foreign exchange regulations in Ethiopia involve intermediary regulations. This is the result of the assignment of trading in forex for limited organizations, Banks, and authorized forex bureaus. Forex transaction in Ethiopia is the normal business of authorized banks licensed by the national bank of Ethiopia.⁸² Therefore, NBE highly regulates the operation of Banks concerning forex transactions to maintain compliance of forex transaction with the existing monetary policy, and ensure stability and availability of forex for international reserves and balance of payments. To this end, the NBE Ethiopia issued directives, among others, Directives FXD.NO.77/2021 which is intended to regulate ‘Transparency in Foreign Currency Allocation and Foreign Exchange Management’. Therefore, this directive imposes a duty on the Banks, primarily the duty of allocating FX to identified priority sectors upon request by the importer. By allocation, the NBE identifies the priority areas where available forex needs to allocate to satisfy the interests, based on the first come first served rule.⁸³ Therefore, Forex shall be allocated to buy essential goods of priority. This helps to guarantee the availability of

⁷⁹ Ibid, Art. 3/1

⁸⁰ Establishment and Operation of foreign currency account for Non-resident Ethiopians and Non-resident Ethiopian Origin (As amended) Directive NO. FXD/ 69/2021, Preamble.

⁸¹ Ibid, Art.8.1

⁸² Banking Business Proclamation No. 592/2008 Art.2/2/c.

⁸³ Transparency in Foreign Currency Allocation and Foreign Exchange Management (as amended) Directives FXD.NO.77/2021, Art.6/1

forex to buy those goods imported, essential in economic development. The directive strictly prohibits the banks not to allocating forex collected from an exporter not importing business of the same outside the proper procedure stipulated.⁸⁴ Some of the respondents recommend that the NBE should focus on a regulatory role instead of strict operational monitoring.⁸⁵

3.3.3.1 Reporting and recording duty by Banks

This is part of prudential regulation to monitor compliance with the authority objectives by banks. To this effect, imposes a duty of preparing regulatory mechanisms for internal bank operation of forex. Accordingly, the board of directors of banks is responsible for preparing regulatory mechanisms; accordingly,

Reporting and recording of forex is another requirement all banks should comply with. Thus, the NBE imposes on the executive management of a bank operational management reporting and recording requirements and disclosure of all necessary information to the NBE. Accordingly, executive management of a bank is under a duty to;

Maintaining records; records of a banks compliance with its own internal forex transaction policies and compliance, and maintain a daily record showing close of business forex, avail information and documentation; Ensuring reporting procedure between head office and branches on daily forex operations; reconciling forex transaction accounts at least every month diligently and provide timely information to the NB concerning the bank's foreign currency open position and outstanding balances; developing and putting in place adequate information system for measuring, controlling, monitoring and reporting the banks daily forex exposure; establish effective internal control to monitor and control overall forex operations; ensuring accounting procedures of forex to meet standards of promptness, accuracy and completeness and maintaining data base.⁸⁶

In addition to the above-mentioned directive, the Establishment and Operation of foreign currency account for Non-resident Ethiopians and Non-resident Ethiopian Origin (As amended) Directive NO. FXD/ 69/2021, provides for reporting requirements of its non-resident forex account status to the foreign exchange monitoring and reserve management directorate and external economy and international relations directorate in the NBE.

⁸⁴ Ibid, Art, 7/1

⁸⁵ Interview with Ato Tewdros Teklehaimanot, import manager at Commercial Bank of Ethiopia, 25 April, 2023.

⁸⁶ Ibid, Art.4

Banks are under the duty to report to the NBE the aggregate balances of forex held under a retention account every month.⁸⁷ A little role as an intermediary through a declaration to the Ethiopian custom commission also attracts the duty of reporting to the NBE all the necessary information as to FX declaration monthly.⁸⁸

3.3.3.2 Surrendering requirement

The NBE imposes the duty to surrender the foreign currency collected by the banks. Hence, banks are required to surrender 70% of foreign currency from export earnings to the NBE.⁸⁹ This is an amount collected from exporters' earnings and recipients of inward remittances. Banks are allowed to retain only 10%. This is regarded as burdensome and banks work only for the benefit of the National Bank of Ethiopia.⁹⁰ Accordingly, one of the respondents says, the NBE should overtake the import and export operation from commercial Banks instead of surrendering.⁹¹ Now, in August 2023 the NBE revised foreign exchange surrendering requirement whereby exporters of goods and services will surrender 50% of their forex proceeds to the NBE, 10% to their bank and retain 40% to their own account.⁹² Therefore, there is a little modification relaxes the requirement currently.

3.3.4 Regulations of trading locations by NBE

Regulation of trading locations involves determining the place or territory within which the domestic currency of Ethiopia can be used as a means of payment in transactions and shows where FX transactions can be legally undertaken. To this end, in Ethiopia it is impossible to undertake transactions involving foreign currency, then, a person may not transfer, or pay foreign currency in cash to a third party either as a donation or gift or to discharge any obligation.⁹³ Accordingly, holding or carrying foreign currency in Ethiopian territory without prior authorization by laws through NBE is illegal. It is possible only if the law provides for who is entitled to carry foreign currency. Regarding domestic currency, there is a limitation as to the maximum amount a person can carry both on departure and entrance. Hence, a maximum amount of 3000 birrs is permissible to hold when departure from and entering Ethiopia per

⁸⁷ The retention and utilization of export earnings and inward remittances directive No. FXD/79/2022, Art.6/1

⁸⁸ Ibid, Art 7

⁸⁹ Ibid, Art.4/1

⁹⁰ All respondents recommend for removal of the surrendering requirement.

⁹¹ Interview with Ato Motuma Sintayewu, Swift and Remittance Expert, Cooperative Bank of Oromia, 25 April 2023.

⁹² Foreign Exchange Surrendering requirement of Banks (as amended) Directive No. FXD/83/2023.

⁹³ Supra note 58, Art.8

travel. Exceptionally, a person traveling to Djibouti is allowed to hold up to a maximum of 10000 birrs per travel.⁹⁴

⁹⁴ Supra note, 58, Art 3/ 1 and 2

CHAPTER 4

4.1 Challenges of Ethiopian foreign exchange regulatory measures

4.1.1 Exchange rate policy

As discussed already in foreign exchange rate regulation, almost all informants consider that Ethiopia adopted managed float exchange rate.⁹⁵ It has been reported that the absence of foreign currency in the market is a challenge for business operations requiring foreign currency.⁹⁶ Accordingly, to correct the problem of FX imbalances under managed float exchange rate system different writers recommends as follows.

“For a country adopting a managed floating exchange rate regime and faced with exchange rate pressures, policy options in the short run are only limited to monetary policy as certain fundamental domestic remedies, like fiscal adjustment and financial sector reform, may require time to implement (often under political stress). To assuage the pressures and reduce EMP, the central bank should react by embracing contractionary monetary policy.”⁹⁷ Moreover, IMF recommends a flexible exchange rate aimed at eliminating misalignments and building up reserves would help competitiveness and foster stability while reducing foreign exchange shortages.⁹⁸ Reiterating the addressed problem, the exchange rate policy of the country has not been resolved yet, balances of payment weakness, unavailability of FX and FX imbalances remain constant up to now.

4.1.2 Forex Exchange restrictions

As part of the regulation of intermediaries particularly Banks, the National banks of Ethiopia provided for different kinds of restrictions in its legislation.⁹⁹ Moreover, the purpose of importing Foreign currency should be allocated to importing pharmaceuticals, and food items,¹⁰⁰ forces diaspora account to allocate their money to priority sectors if wish to engage in importing business,¹⁰¹ imposes an obligation on banks of surrendering up to 50% of the foreign currency

⁹⁵ Interview with Ato Birhanu Lami, Oromia International Bank S.C, Senior International Trade Service Officer, 17 April 2023.

⁹⁶ Ibid

⁹⁷ Abebe Deressa, p.3

⁹⁸ 2018 Article Iv Consultation—Press Release; Staff Report; And Statement By The Executive Director For The Federal Democratic Republic Of Ethiopia, IMF Country Report No. 18/354, Dec 2018.

⁹⁹ The NBE Directives provided for the allocation of FX with priority sectors, surrendering of FC, restriction on the diaspora account, and direction of the use of retention accounts by exporters.

¹⁰⁰ FXD.No/77/2021, Art.6

¹⁰¹ FXD.NO/69/2021, Art.8

from export of goods and services, private transfers and NGO'S to the NBE.¹⁰² Whereas the IMF¹⁰³ identifies that this kind of exchange restrictions is regarded as inconsistent with article VIII, sections 2(a), 3 and 4.

Asymmetric regulation is considered another foreign exchange market policy mistake in some countries.¹⁰⁴ Asymmetric regulation comes into the picture when the authority issues regulation with the motive of capital inflows without considering capital outflows or insisting rigidly on avoiding capital outflows.¹⁰⁵ The restriction extends to the number of cash notes allowed for the commercial banks to hold.¹⁰⁶ Accordingly, the regulator with the objectives of facilitating smooth purchase and selling and proper management of foreign currency set the amount possibly hold by banks.¹⁰⁷ To this end, the commercial banks paid up capital is the frame of reference to allow the exact amount they would hold.¹⁰⁸ Hence, Commercial banks can only hold up to 5 percent of their paid-up capital in foreign currency cash notes as a working balance at the close of each calendar month. Any excess holding shall be surrendered to the NBE within 5 working days from the end of the calendar month.¹⁰⁹ This limitation applies since 2004 for almost 2 decades not yet revised. It is burdensome for commercial banks as compliance with this requirement makes the foreign currency status of banks insufficient to meet the market demands.

Furthermore, with respect to Ethiopia's capital outflows, the existing regulation is strict and imposes high substantive and procedural conditions to export foreign currency out of Ethiopia. Typically, licensing and registration is a prerequisites to repatriate money in the form of foreign currency out of Ethiopia.¹¹⁰

4.1.3 Organization of Forex Laws

A logical organization of laws, particularly of forex laws, is critical for the proper comprehension of the forex system. Different legal systems organize their forex laws differently,

¹⁰² Foreign Exchange Surrendering requirement of Banks (as amended) Directive No. FXD/83/2023.

¹⁰³ Supra note 93, Para.33

¹⁰⁴ Woo-Sik Moon and Yeong-Seop Rhee, Foreign Exchange Market Liberalization Policies in Korea: Past Assessment and Future Options, *Journal of International and Area Studies*, June 2000, Vol. 7, No. 1 (June 2000), pp. 59-79, <https://www.jstor.org/stable/43107026>.

¹⁰⁵ Ibid Supra note 93, Para.33

¹⁰⁶ The limitation of holding cash note of foreign currency by commercial banks were restricted by DIRECTIVE NO. FXD/23/2004 FOREIGN CURRENCY CASH NOTES HELD BY COMMERCIAL BANKS

¹⁰⁷ Ibid, preamble

¹⁰⁸ Ibid, Art.2

¹⁰⁹ Ibid

¹¹⁰ Investment Proclamation No1180/2020, Art. 16 and 20

ranging from those countries that organize their forex laws in codes to those that issue forex laws in scattered pieces of legislation. The organization of forex laws in different legal systems is one minor paradox. The status of a country as a civil law country has not had any impact on the codification of forex laws.

Organization of forex laws in a code has many advantages. Judged purely in terms of accessibility and intelligibility, the organization of rules in a formal code with the logically coherent arrangement of rules is without doubt the most preferred form of rule organization. By organizing all general areas of definitions and administrative provisions in a single section, codes help eliminate duplication of definitions and administrative provisions in individual pieces of legislation. Codes overcome the possible treatment of general definitions and administrative provisions in separate pieces of forex legislation and help avoid differing and at times conflicting interpretations. Codification of forex laws also helps to rationalize the organization of the whole forex system because, in a code system, one is forced to think of the whole, of the forest rather than just the trees.

Finally, where laws are organized in a code, subsequent amendments can be automatically consolidated into it by adding sections or articles to it or repealing or replacing the language of the Code. Organizing forex laws in a forex code is not always desirable, even if possible.¹¹¹ Only rules of general application with the power to endure the test of time can be organized in codes, while ephemeral rules should be contained in specific forex laws that are more amenable to frequent revisions and amendments. In fact, Ethiopia's legal system is categorized as civil law legal system since most of the legislation is codified in one single document followed by specific modification in other specific legislation if necessary.¹¹²

4.1.4 Inconsistency of power of making laws with accepted rule

Most of the substantive laws about forex flow from regulations and directives. As known in different laws of Ethiopia, substantive laws are provided in the proclamation. Whereas, regarding forex, we couldn't find a proclamation incorporating substantive provisions for the administration of forex. Even instead of finding substantive provision in other laws, easy to find

¹¹¹ The nature of forex laws is dynamic and throughout the world economic integration is growing at a fast speed which requires immediate adjustment on the part of countries to balance changes in the circumstance to avoid economic loss, particularly forex is a hot issue due to international trade increment.

¹¹²The trend of codification started in the early 1960s following the modernization of the legal system in the country. Later on, civil code, commercial code, penal code, and maritime code were enacted the then.

substantive provision for forex in directives issued by the NBE. To be sure, forex regulations and directives are derivative legislations – issued only according to the authority given in the forex proclamation. However, in terms of the subject matter covered in the forex directive, there are substantive provisions we wish to see at the proclamation or regulation level.

The power of the NBE to regulate foreign exchange is vested by the establishment of Proclamation No.591/2008 of the NBE and investment proclamation No.1180/2020. Therefore, the NBE as per the proclamation has the derivative or delegated authority to regulate forex. Moreover, NBE is an administrative authority for which issuing substantive laws is constitutionally impossible. Practically, the directive issued by the NBE provides for some kind of substantive provision that is odd and against the division of power among organs of government. If you look into Directive NO.FXD/69/2021 was issued for the establishment and operation of foreign currency accounts by non-resident Ethiopian and non-resident Ethiopian origin as amended, article 10/1, in principle it prohibits payment of interest to a Non-resident foreign currency account which is fundamentally against the payment of interest on deposits.¹¹³ This has the effect of differential treatment among customers based on the nature of their account. Moreover, deviates from the uniformity standard of the banking operations. Moreover, it provides for an incentive in the form of exempting interest income on non-resident foreign currency fixed deposit accounts from income tax.¹¹⁴ This is going beyond the authority of NBE since determining tax exemption is given for tax authority.

In addition to this, the Directive issued to regulate “Foreign Exchange Transaction in Industrial Parks Directive No. FXD /60/2018” entitles substantive rights to investors in industrial parks to buy and sell raw materials by foreign currency from their currency account or retention account.¹¹⁵ Moreover, this right is substantive in its nature, which the administrative body, NBE can’t by directives permits upon its initiation under the delegated authority. As well, we can find an entitlement of right by the NBE Directive No.FXD/66/2020 was issued for the regulation of retention and utilization of export earnings and inward remittances, the right to retain for an indefinite period an amount of 30% of foreign currency earned by exporters of goods and

¹¹³ Establishment and Operation of foreign currency account for Non-resident Ethiopians and Non-resident Ethiopian Origin (As amended) Directive NO. FXD/ 69/2021.

¹¹⁴ Ibid, Article 15.2

¹¹⁵ Foreign Exchange Transaction in Industrial Parks Directive No. FXD /60/2018, Article 4

services and recipient of inward remittances.¹¹⁶ This allows retaining their foreign currency in retention account indefinitely without limitation of time.

In a nutshell, the aforementioned substantive right addressed in the directive is a limited figure used to show an example of the issuance of law outside of the authority of an administrative organ, like NBE. But we can in many of the directives of the National Bank provision have the same nature. Finally, Ethiopian forex regulation goes against the division of power among the organs of government.

4.1.5 Diversity of directives

Forex directives do not get as much attention in academic writing and court cases as they deserve but they are issued in large numbers by administrative agencies or bodies associated with forex administration particularly, NBE. With the strengthening of the forex administration organ and widening of the investment sector, we have seen an increasing number of directives in foreign exchange. Following the increasing number and diversity of directives, the difficulty of classifying them, repetitions of terminology, and misunderstanding may arise. Subjects or things under regulation can be categorized into a set of comprehensive inclusive of the issue scattered here and there under different directives. By doing so, the authority could decrease the complexity and misunderstanding of the directives. Particularly, the complexity that may come from a definitional part of directives. In each directive, we find the definition of the same terminology, let's say the definition of 'Bank, National Bank, person, etc.', here and there. This is something unnecessary and better to be avoided. For the betterment of management and uniformity of forex laws, it is advisable to put them in a codified manner if possible or put it in one legal document (directives).

4.1.6 The development of a parallel market

Many central banks operate a managed exchange rate policy: this is in most cases a peg against a single currency (normally the USD or EUR) or a basket of currencies, and typically with a narrow trading range or a stabilized real effective exchange rate. Maintaining a single exchange rate market so that the official exchange rate is relevant to the real economy, and legitimate current account transactions can be undertaken easily at or near the official rate—means the central bank needs to ensure that demand and supply for FX against the domestic currency are

¹¹⁶ The retention and utilization of export earnings and inward remittances Directive No.FXD/66/2020, Article 5/1.a

balanced over time.¹¹⁷ If the central bank has ample FX reserves, and FX inflows at least equal outflows, managing such an exchange rate policy may be relatively straightforward (though it will have consequences for other policy actions and the economy that may be more challenging).

¹¹⁸ The central bank, in this case, is the price maker.

In other cases, the central bank's official rate will simply be a reflection of the (flexible) market-clearing rate, and the central bank is a price taker. Official FX reserves can of course act as a short-term buffer if the FX market is thin (demand and supply will not be in balance from day to day). Several central banks operate an FX intervention (FXI) policy that aims to lean against excessive short-term price volatility.¹¹⁹ From time to time, a central bank may find that it is no longer able to maintain a managed exchange rate for current transactions where the central bank is the price maker because it can no longer ensure that supply of FX is sufficient to meet demand at that price. This tends to happen when the authorities are reluctant to allow the exchange rate to adjust fully in response to excessive fiscal stimulus perhaps "supported" by monetary financing that leads to high inflation and balance of payments weakness. It may also reflect shocks to the economy, for instance where a commodity-exporting country suffers from a substantial and persistent decline in the global price of that commodity. In several countries, the COVID-19 crisis has led to a balance of payments weakness, associated with a fall in remittances, or a sharp decline in tourism revenues, in addition to commodity price shocks.¹²⁰

But sometimes central banks maintain an overvalued official exchange rate at which supply does not meet demand and instead attempt to restrict demand administratively. They may do so by prioritizing certain transactions; rationing FX; allowing queues to develop; or setting ceilings for, or even prohibiting, certain current payments.¹²¹ In some cases, the central bank determines two or more "official" rates. A range of preferential exchange rates may be used for different sectors or items e.g., one rate for fuel imports, a second for basic foodstuffs, and so on. A multiplicity of official exchange rates is likely to give rise to multiple currency practices (MCP) under Article VIII of the IMF's Articles of Agreement. The approach of using one or more official rates may

¹¹⁷ Simon T Gray, *Recognizing Reality: Unification of Official and Parallel Market Exchange Rates*, IMF Working Paper, p.6.

¹¹⁸ Ibid

¹¹⁹ Ibid

¹²⁰ Ibid, P.6

¹²¹ Ibid, p.6

be supported by a belief that a strong currency will mean higher growth and lower inflation while ignoring the underlying problems—such as excessive fiscal stimulus and/or monetary financing—that cause exchange rate weakness and inflation. It may also be promoted by those who can profit from privileged access to FX at the official exchange rate (rent-seeking behavior). Some may initially have hoped that an exogenous shock causing exchange rate weakness will quickly be reversed, thus avoiding the need for policy changes, but fail to adjust when the situation is prolonged.¹²²

In such cases, a parallel market for current transactions will develop as many economic agents will, if possible, move transactions to the parallel market, whether to obtain a better price if selling FX or because they cannot obtain FX at the official price. The wider the spread between the official and parallel rates, the greater will be the incentive to channel FX to the parallel market. At the extreme, the “parallel” market may be the only reliable source of FX for the majority of participants in the economy.¹²³ The central bank is then acting as if it were a price maker, but without the “fire-power” (FX that is available and it is willing to use) to implement its chosen price effectively.¹²⁴ Arguably, the parallel market represents economic agents’ solution to a problem created by the central bank. Price levels in the economy are likely to reflect the parallel market rate, either because that is the rate most people and companies have to use, or because those with access to the official rate can benefit by taking excess profits, or expect the possibility of a significant depreciation shortly and set prices accordingly.¹²⁵

Coming to Ethiopian forex exchange rates, Directive No. FXD/59/2018 declares the managed float exchange rates daily for both cash and transaction.¹²⁶ Accordingly, 1) the foreign exchange buying rate of a bank shall be the NBE interbank foreign exchange market indicative buying rate of the day. 2) The margin set between the buying and selling rate of the bank shall not exceed 2% (two percent) from the NBE interbank foreign exchange market indicative buying rate of the day. 3) Daily buying and selling rates shall be posted in a publicly visible place and the bank

¹²² Ibid , p.7

¹²³ Ibid

¹²⁴ Ibid

¹²⁵ Ibid, P.8

¹²⁶ Fixation of the daily foreign exchange cash notes on Transaction rate (as Amended) Directive No. FXD/59/2018, Article 3

shall use the posted rate throughout the day. 4) A bank may buy foreign exchange from the retention account holder at a negotiable rate not exceeding its selling rate of the day.¹²⁷

The above-mentioned legal provisions show us that the managed exchange rate is regulating forex in Ethiopia. Whereas, only a limited group of market participants can get forex at the official rate.¹²⁸ Moreover, malpractice regarding access to forex arises and causes the development of a parallel (black) market. Even the scope of the market is voluminous and high in the number of transactions that take place daily. Furthermore, its influence on the ordinary market is by far greater than other factors. In a nutshell, the price in the unofficial market pushes recipients of forex and Ethiopians in Diaspora to import forex through informal market channels to take advantage of the market there.¹²⁹

4.2 The Next Reform Areas

Regulation of foreign exchange is one mechanism through which the monetary objectives of the country are achieved. The monetary policy of the country needs to continue to focus on the Objectives of controlling exchange rate stability and balance of payment equilibrium.¹³⁰ That is why systemic stability regulations are devised by the NBE. According to Dr. Solomon Abay's (Ph.D.) recommendation regarding the regulation of the financial market, the NBE is encouraged to shift its role from direct to indirect controls of foreign exchange, urge the NBE to build their foreign exchange “absorption risk capacities and formalize and regulate the hitherto existing informal foreign currency exchange market which is often known as the black or parallel market.”¹³¹

Foreign exchange regulations in most jurisdictions including Ethiopia have certain common objectives to attain. The primary objective is, securing exchange rate stability, balance of payment, and availability of foreign currency, among others. Moreover, transparency in allocation and management, efficiency, and fair market development may be considered

¹²⁷ Ibid

¹²⁸ The prioritization of sectors in the allocation of forex to pharmaceuticals and foods gives privilege to the importers of these products. After having allocated FX at hand by Banks due to its scarcity for the late comers FX is unavailable and impossible to access formally.

¹²⁹ Interview with Interview with Ato Birhanu Lami, Oromia International Bank S.C, Senior International Trade Service Officer, 17 April 2023.

¹³⁰ Solomon Abay, Financial Market Development, Policy, and Regulation: The International Experience and Ethiopia's Need for Further Reform, 2011. P.357.

¹³¹ Ibid, p.362.

objectives of foreign exchange regulation. Accordingly, the following will be the next reform areas considering the importance of FX market. These are;

4.2.1 Foreign exchange market policy

Foreign exchange markets were and continue to be distorted in Ethiopia.¹³² Market forces play a very limited role in the formal foreign exchange regime.¹³³ The government continues to follow overvalued exchange rate system with the motive of facilitating cheap import for manufacturing under HGRA as a driver of economic success.¹³⁴ Whereas the measures skyrocketed the imbalance in forex instead of meeting the objectives.¹³⁵ Overvaluation of exchange rate causes FX shortages since the import is easy compared to export and the market drive towards importing.¹³⁶ Currently, this overvalued exchange rate contributes to the current account deficit.

4.2.2 Adopting full-fledged liberalization of foreign exchange market

There is no denying that financial and foreign exchange market liberalization enhances market efficiency and economic welfare. But the benefit does not come without cost. The cost is increasing instability in the economy and this risk is especially high because government authorities are incapable of managing their economies appropriately.¹³⁷ However, slow measures of liberalization is better.

4.2.3 Adoption of flexible exchange rate system

The inflexibility of exchange rate policy is considered one of the factors causing FX imbalances.¹³⁸ Accordingly, a flexible exchange rate is desirable and better to correct FX imbalances. Most of the respondents consider the existing exchange rate system as a fixed exchange rate.¹³⁹ Thereby recommends flexible exchange system as a solution.

4.2.4 Recognizing and regulating parallel exchange market

For all legitimate current account transactions, there should be a single exchange rate; but in some countries, there are two (or more) exchange rates for current account transactions an

¹³² James Lloyd and Bisrat Teshome, Foreign Exchange Allocation and Access for Businesses in Ethiopia, Business Environment Reform Facility, Oct 2018.

¹³³ Ibid

¹³⁴ Ethiopia's Homegrown Reform Agenda, 2019, p.7

¹³⁵ Interview with Ato Tesfaye Ambasse, Import Manager, Awash Bank S.C on 17 April 2023.

¹³⁶ Ibid

¹³⁷ Woo-Sik Moon and Yeong-Seop Rhee, Journal of International and Area Studies , June 2000, Vol. 7, No. 1 (June 2000), pp. 59-79, <https://www.jstor.org/stable/43107026>

¹³⁸ Ibid

¹³⁹ Interview with Ato Paaulos G/Mariam, Wegagan Bank, FB and Remmittance, Manager on 18 April, 2023, interview with Ato Tesfaye Ambasse of Awash Bank S.C.

“official” rate at which demand for FX is not fully satisfied, and a parallel market rate.¹⁴⁰ This may contravene the country’s obligations under the IMF’s Article VIII.¹⁴¹ It may be “difficult to treat the spreads arising in illegal parallel markets as the result of an official action, given that the authorities themselves have prohibited transactions from taking place in that market” (IMF 2019, para 37), the existence of parallel FX markets—and the problems associated with this phenomenon—are very real.¹⁴² Balance of payments weakness and associated exchange rate pressures, related to COVID-19, have seen an increase in such cases.

An “official” exchange rate is here used to mean an exchange rate that commercial banks and other regulated entities are legally required to use when recording actual transactions, and for instance when calculating customs and tax liabilities.¹⁴³ It may also be used for statistical purposes. The official exchange rate should reflect the actual exchange rate used in market transactions, whether because the official rate determines market rates (supply is sufficient to meet demand), or simply reflects the actual market rate. In some cases, authorized FX dealers are legally allowed to set exchange rates freely, but the central bank then uses informal guidance (“immoral suasion”) to keep the official market exchange rate at a desired level.¹⁴⁴ Where capital controls are in place, the existence of the controls nearly always results in a parallel foreign exchange (FX) market, since some economic agents will be prepared to pay a price to evade the controls—which may range from just a few percentage points under “normal” conditions and if the financial account is not entirely closed, to a much larger spread if socio-economic conditions lead to demand for large movements of funds and the financial account is fully closed.¹⁴⁵ A parallel FX market may also exist for illegal transactions. e.g., money laundering, narcotics trades, and human trafficking even in the absence of capital controls.¹⁴⁶

¹⁴⁰ Simon T Gray, *Recognizing Reality: Unification of Official and Parallel Market Exchange Rates*, IMF Working Paper, WP/21/25.

¹⁴¹ Ibid, “Article VIII Section 3 prohibits multiple currency practices (MCP) without the approval of the Fund. Under the Fund framework, an MCP is defined by the Fund as an action by a member or its fiscal agencies that “of itself gives rise to a spread of more than 2 percent between buying and selling rates for spot exchange transactions between the member’s currency and any other member’s currency.”

¹⁴² *Supra* note 113

¹⁴³ *Ibid*

¹⁴⁴ *Ibid*

¹⁴⁵ *Ibid*

¹⁴⁶ *Ibid*

According to IMF, the “parallel” market may be the only reliable source of FX for the majority of participants in the economy.¹⁴⁷ The central bank is then acting as if it were a price maker, but without the “fire-power” (FX that is available and it is willing to use) to implement its chosen price effectively. Arguably, the parallel market represents economic agents’ solution to a problem created by the central bank. Price levels in the economy are likely to reflect the parallel market rate, either because that is the rate most people and companies have to use, or because those with access to the official rate can benefit by taking excess profits, or expect the possibility of a significant depreciation in the near future and set prices accordingly.¹⁴⁸

Parallel markets exist for real in the Ethiopian exchange market.¹⁴⁹ The transaction taking place is high both in the number of market participants involved and the volume of transactions. Whereas Central Bank maintains an Overvalued official exchange rate at which supply doesn’t meet demand, and resort to taking administrative measure of restricting demand. E.g. measures undertaken by the government to restrict the import of 38 items on October 14, 2022 is typical example.¹⁵⁰ Not only its existence but also the exchange rate for transactions is very high compared to the official exchange rate. Sometimes it reaches the point at which access for market participants is too burdensome. This induces market participants to join the black market for current transactions. Considering a better price when selling FX, or cannot obtain FX at the official rate for buying, the channel of the parallel market became too high. The official exchange rate or obtaining FX at the official exchange rate is possible for priority sectors or those with privileged access as per the NBE directive. Therefore, the alternative is a black market for others.¹⁵¹

According to the IMF report, the measure of insisting on applying an official exchange rate and not recognizing parallel market reality results; in uncertain availability of FX, it is always uncertain whether the business will be able to operate effectively and profitably, Some companies with a viable business may have to cease operating, or reduce operating capacity

¹⁴⁷ Ibid

¹⁴⁸ Supra note, 135

¹⁴⁹ Supra note, 133

¹⁵⁰ <https://apps.fas.usda.gov/newgainapi/api/Report/DownloadReportByFileName?fileName=Ethiopia%20bans%20import%20of%2038%20items%20including%20packed%20food%20Addis%20Ababa%20Ethiopia%20ET2022-0031.pdf>, accessed on 1 march, 2023.

¹⁵¹ Interview with Ato Birhanu Lami, Senior International Trade Service officer of Oromia Bank S.C, Finfine Branch on 18/04/2023

because they cannot maintain machinery if spare parts need to be imported. Potential new business ventures may be reluctant to start up, FDI will also be discouraged, and Statistics and corporate accounts will be distorted: in addition to under- and over-invoicing by exporters and importers, banks that have to book transactions at the official, a non-market rate may add other fees and costs to cover the real exchange rate used, complicating corporate accounts. Corporates may post lower than actual profits (reflecting under-and over-invoicing), thus reducing government tax revenues. An overvalued exchange rate motivates informal channels for remittances, the interbank FX market will be thin or non-existent, and Rent-seeking and dishonest practices are in effect encouraged. Large and persistent parallel premiums create numerous microeconomic distortions. Some economic agents will respond to the incentives by seeking to profit from privileged access to FX at the official rate or misstate accounts to offset the impact of misaligned official rates on business activities.

Finally, there may be spill-over to the property market, where investors postpone entry into the market in part because they are waiting for the expected further real depreciation of the domestic currency. One consequence of the further downward pressure on the property market is that the valuation of collateral held by banks is reduced, making banks reluctant or unable to extend further credit. In conclusion, recognizing reality as to the existence of a parallel market and regulating is the better mechanism.¹⁵²

¹⁵² Interview with Ato Ermias Teshome, Trade, and Service, Manager at Zemen Bank S.C on 20/04/2023

4.3 Concluding Remarks and Recommendation

4.3.1 Conclusion

The researcher identifies the potential challenges in the regulation of the foreign exchange market of Ethiopia. Accordingly, most of the forex market problems in Ethiopia attributes to regulatory failure on the part of the authority. Nonetheless, corruption and bureaucracy in the allocation and management intensify the challenges and hinder access to forex by market participants. Moreover, unavailability of forex in the market is reported most of the time as a result of regulatory failure.

Furthermore, management of exchange rate policy, exchange restrictions, organizations of forex regulation, development of the parallel market, making of laws affecting the forex market, and diversity of directives in the area of Ethiopian forex market regulation contributes to the distortion of regulation.

Regulation of the foreign exchange market is considered essential and has a significant impact on the development of a country directly or indirectly. It is not as simple as we think of the term from the outside, it is complex and requires technical and critical investigation for proper regulation. Unless it costs the monetary policy of a country to face an economic crisis as learned from different countries experiences. The concept of regulation of forex is eclectic and a pressing issue given the impact of forex in the administration of monetary policy of a country, particularly of emerging economies like Ethiopia.

The importance of regulation is not an issue of debate regarding forex, whereas the manner of regulation, timing, and mechanisms of regulation is. The balance of payment deficit, unavailability of forex, the sensitivity of forex in monetary policy, and the overall impacts of forex on the economic development of the country justify regulation. Moreover, transparency in management and allocation, the integrity of the market, and efficiency in the market may be considered a prerequisite for regulation.

The foreign exchange market structure and the associated regulations are closely related to the development, liquidity, and volatility of the foreign exchange market. Moreover, the regulations shape the flow of forex transactions, set an institutional means of its exploitation, direct the behavior of market participants, and imply the government monetary policy.

Foreign exchange transactions are believed to be one part of the banking business in Ethiopia. Therefore, the mandates of regulating and administering forex transactions are entrusted to the NBE by banking business and investment proclamation. Following its mandates the NBE started issuing directives as an instrument of regulation of the foreign exchange market for half a century. The very objective of the regulations was, and are to maintain exchange rate stability, put in place sound and efficient management, ensure transparency and maintain balance of payment ability, and guarantee availability of foreign currency for the smooth operation of the business. In fact, forex transaction is under strict regulation taking into account the scarce nature and importance of international trade and investment. Moreover, the existence of high competition to access and its unavailability justify the strict regulation.

Accordingly, the regulation recognizes that forex transaction is a banking business. Having recognizes this; the authority focuses on showing the direction through regulatory measures as to how banks conduct forex transactions. In doing so, forex laws regulate the exchange rate of the prices on a daily basis with reference to interbank market prices. This implies that Ethiopian forex regulation follows managed float foreign exchange rate. Whereas, it is considered to be challenging because of forex imbalance, unavailability, and balance of payment weakness. Hence, For a country adopting a managed floating exchange rate regime and faced with exchange rate pressures, policy options in the short run are only limited to monetary policy as certain fundamental domestic remedies, like fiscal adjustment and financial sector reform, may require time to implement (often under political stress). Moreover, IMF recommends flexible exchange rates aimed at eliminating misalignments, and building up reserves would help competitiveness and foster stability while reducing foreign exchange shortages.

Despite, the existing objectives of correcting forex market imbalances through liberalization of regulation as per the homegrown reform agenda of 2019, the regulatory frameworks continue to follow forex restrictive measures. Moreover, most of them are inconsistent with the IMF Articles of Agreement. These are surrendering requirements, and allocation of forex to priority sectors. Furthermore, asymmetric regulations are out there because some regulations are highly focused on increasing forex capital inflow to the country neglecting outflows of capital by market participants through restricting exporting of forex. In addition, licensing and registration is

another prerequisite in order to repatriate money out of the country in foreign currency which is against free flows of currency in the international market.

There is little measure of liberalization of the foreign exchange market after 2018 in general. Taking into account the role of foreign investors in economic development the government remove prohibitions as to remittance of funds by foreign investor. Investment Proclamation No.1180/2020 permits any foreign investor in respect of his investment to remit the payments and earnings in convertible foreign currency, the payment like profit and dividend accruing from his investment. But in advance capital registration requirement is mandatory within one year and obtain a certificate of registration. Whereas domestic investors jointly working with foreigners are still prohibited from remitting their earnings out of Ethiopia. Therefore, there is no full-fledged liberalization of forex market regulation in Ethiopia.

In the banking business, non-resident Ethiopian and non-resident foreign nationals of Ethiopian origin, shareholding prohibitions were removed. The banking business proclamation no.1159/2019 stipulates that “if a foreign national of Ethiopian origin holds directly a share in a bank or indirectly by holding a share in another organization that holds a share in a bank, a foreign national of Ethiopian origin or the organization in which he is a shareholder, shall pay the values of the share in the bank only in acceptable foreign currency only.” Here foreign currency having acceptance by the NBE can serve as payment for the buying of shares in a bank. Notwithstanding, the obligation of payment to buy shares in foreign currency, repatriation is impossible. Hence, all types of payments due to foreign nationals of Ethiopian origin resulting from dividends, earned from a share in a bank, transfer of share in a bank, sales or liquidation of a bank, or any other matter related to shareholding in a bank shall be paid to him in local currency and he shall not be allowed to repatriate any asset or interest obtained in this manner. Hence, so long as repatriation of all kinds is impossible liberalization is not full-fledged.

The NBE assumes authority still over the exchange market in addition to the wide or bulky nature of its responsibility in the financial market. In fact, a delegation of monitoring, administering, and supervising the foreign exchange market is better to be delegated to a special body specializing in the foreign exchange market.

Regardless of the existing reality concerning parallel markets the authority takes the position of bird eye view, looking from above, from the sky, or put hands off to take certain regulatory

measure, either in recognizing and regulating or unifying with the official foreign exchange market. The difficulty of accessing foreign currency at the interbank rate resulted in the development of a parallel market. A parallel market for current transactions will develop as many economic agents will move transactions to the parallel market, whether to obtain a better price if selling FX, or because they cannot obtain FX at the official price. The wider the spread between the official and parallel rates, the greater will be the incentive to channel FX to the parallel market. At the extreme, the “parallel” market may be the only reliable source of FX for the majority of participants in the economy. Currently, only a limited group of market participants can get forex at the official rate. Moreover, the malpractice regarding access to forex arises and causes the development of a parallel (black) market. Even the scope of the market is voluminous and high in the number of transactions that take place daily.

Forex law is not well organized and comprehensively provided under one legal document, particularly in code form. This may be justified by the dynamism of forex in its nature with the development, and expansion of international trade and investment, and the growing financial infrastructure. However, where laws are organized in a code, subsequent amendments can be automatically consolidated into it by adding sections or articles to it or repealing or replacing the language of the Code. Organizing forex laws in a forex code is not always desirable, even if possible.

Most of the forex law is found in directives issued by NBE. Therefore, directives regulating forex are many in number, and redundantly stipulate the same legal provision here and there which causes ambiguity and difficulty in implementation. The authority issues directive independently for petty subject matters since putting them in one single document is possible. This is even burdensome and costly for the authority.

The writer has analyzed the existing legal regime governing foreign exchange in Ethiopia and identified the potential challenges and next reform areas and considers the following recommendations appropriate for the regulation of foreign exchange.

4.3.2 Recommendation

It has been said that the foundation for ensuring proper, effective, and transparent operation foreign exchange market through regulations generally exist. It is known that the government undertaking the liberalization measure of the financial market in general as part of homegrown

economic reform policy. Therefore, further liberalization measures of the foreign exchange market are expected from the NBE considering the significant contribution of the market to economic development. The writer for this purpose recommends the following;

- The NBE with its stakeholders should have to reconsider the structure and organization of foreign exchange regulations, taking into account the simplicity, effectiveness, and understandability of the laws, organized it in a legal document as much as possible, particularly in a coded form.
- The plurality or multiplicity of directives issued for the purpose of regulating foreign exchange needs to be reduced. Because, their diversity opens room for redundancy, ambiguity, and gaps which paves the way for malpractice.
- The working fixed exchange rate should be removed and better to adopt a flexible exchange rate, of the fact that the latter contributes to decreasing FX imbalances. Because fixed exchange rate causes the development of a black market as market participant highly flows to the informal market channel seeking a better price.
- Surrendering requirements imposing 50% of obtained foreign currency through exporting of commodities and services by recipients should be removed.
- Limitation on repatriation of, company earnings, dividends, profit, transfer of share in a bank, sales or liquidation of a bank, or any other matter related to shareholding in a bank by foreign national of Ethiopian origin from their shareholding in a bank should be removed.
- Restriction on the repatriation of foreign currency by domestic investors should be removed.
- The issue of the parallel or black market should be taken due consideration. Hence, the National Bank of Ethiopia should recognize the existence of the market and its contribution to the market. Thereafter, it should regulate the market. This helps in generating revenue from the market and paves the way for interfering in the informal market channel ongoing.
- The national bank of Ethiopia should allow current account liberalization for smooth movement of currencies enabling individual making payment easily.

- The regulations also should allow a resident, without the need for prior national Bank approval, to make investments abroad funded by foreign exchange purchased from Banks.
- Further Liberalization measures on foreign exchange regulations are required with strict procedural and implementation supervision by NBE.

Annexes

Interview questions for NBE

1. What are the potential challenges for implementation of forex regulation in operation?
2. What is the main cause for the development of parallel market? Why the NBE didn't regulate the parallel market?
3. Which areas of regulations do you think better to be revisited, modified and amended to fit to the challenges you raised above?
4. Do you think reform required, in the overall regulation?
5. Why the authority reluctant to adopt flexible exchange rate?

For Bank

1. Do you think foreign currency account adds value to your bank foreign exchange earning? Is diaspora account serves its purpose?
2. How do you see the existing exchange rate system?
3. Does surrendering requirement by the NBE comply with your Bank business goal?
4. How do you see the parallel market?

Letter from Addis Ababa University



Addis Ababa University
 College of Law & Governance Studies
 Office of the Coordinator for Graduate Extension Programs

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Date: April 17, 2023

To: Aklash Bank S.c

Dear Sir/Madam:

Guts Hita is a _____ year graduate student in the Law School of Addis Ababa University. As part of a coursework, he/she is doing a research on Regulation of foreign exchange market ; Challenges & the next reform areas

"We would appreciate if the above-mentioned student is given access to you collections and/or resources in accordance with the arrangements the student may make with your good office.

Thanking you for any assistance you may provide to the above-named _____

Best Regards,

Amerji Solomon

Coordinator for Graduate Programs
 College of Law and Governance Studies.

Amari Solomon
 0115-59-01-28
 Import, (Foreigner)
 (Prepare) *Amari Solomon*



Addis Ababa University
College of Law & Governance Studies
Office of the Coordinator for Graduate Programs

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Date: 18/04/2023
MGR. F/BKJ & Renu
For your cooperation
18/04/2023

To: Wepasen Bank S.C

Dear Sir/Madam:

Guto Hika is a _____ year graduate student in the Law School of Addis Ababa University. As part of a coursework, he/she is doing a research on Regulation of foreign Exchange Market: Challenges of the next reform areas

"We would appreciate if the above-mentioned student is given access to you collections and/or resources in accordance with the arrangements the student may make with your good office.

Thanking you for any assistance you may provide to the above-named student!

Best Regards,

Ameri Solomon

Coordinator for Graduate Programs
College of Law and Governance Studies.

Director, Trade Service
For your usual cooperation
18/04/2023



Addis Ababa University
 College of Law & Governance Studies
 Office of the Coordinator for Graduate Extension Programs

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Date: April 17, 2023

To: Nib International Bank S.c

Dear Sir/Madam:

Gutsu Hika is a _____ year graduate student in the Law School of Addis Ababa University. As part of a coursework, he/she is doing a research on Regulation & foreign Exchange : challenges of the next reform areas

'We would appreciate if the above-mentioned student is given access to you collections and/or resources in accordance with the arrangements the student may make with your good office.

Thanking you for any assistance you _____ the above-named student!

Director, Trade Finance Department
 The above mentioned AAU student is requesting support to undertake research on the captioned topic. If you can ~~assist~~ provide the requested support we are ready to facilitate the subsequent formalities.
 17/04/23



Addis Ababa University
 College of Law & Governance Studies
 Office of the Coordinator for Graduate Extension Programs

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Date: April 17, 2023


To: Oromia Bank S-C

Dear Sir/Madam:

Guto Hika Tasisa is a _____ year graduate student in the Law School of Addis Ababa University. As part of a coursework, he/she is doing a research on Regulation of foreign Exchange : challenges and the Next reform areas

"We would appreciate if the above-mentioned student is given access to you collections and/or resources in accordance with the arrangements the student may make with your good office.

Thanking you for any assistance you may provide to the above-named student!

Best Regards,

 Amert Solomon

Coordinator for Graduate Programs
 College of Law and Governance Studies.



Addis Ababa University
 College of Law & Governance Studies
 Office of the Coordinator for Graduate Extension Programs

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Date: 20/04/2023

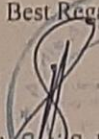
To: Zemen Bank S.C

Dear Sir/Madam:

Guto Hika is a _____ year graduate student in the Law School of Addis Ababa University. As part of a coursework, he/she is doing a research on Regulation of Foreign Exchange market: Challenges & the next reform areas

We would appreciate if the above-mentioned student is given access to your collections and/or resources in accordance with the arrangements the student may make with your good office.

Thanking you for any assistance you may provide to the above-named student!

Best Regards

 Ameni Solomon
 Coordinator for Graduate Programs
 College of Law and Governance Studies.



Addis Ababa University
 College of Law & Governance Studies
 Office of the Coordinator for Graduate Extension Programs

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Date: 20/04/2023

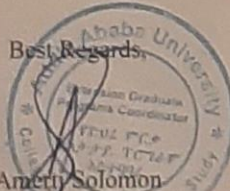
To: Commercial Bank of Ethiopia

Dear Sir/Madam:

Guto Hika is a _____ year graduate student in the Law School of Addis Ababa University. As part of a coursework, he/she is doing a research on Regulation of Foreign Exchange market: Challenges & the next reform areas.

"We would appreciate if the above-mentioned student is given access to you collections and/or resources in accordance with the arrangements the student may make with your good office.

Thanking you for any assistance you may provide to the above-named student!

Best Regards,

 Amertu Solomon
 Coordinator for Graduate Programs
 College of Law and Governance Studies.

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