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**ADDIS ABABA UNIVERSITY COLLEGE OF
BUSSINESS AND ECONOMICS SCHOOL OF
COMMERCE**

**ASSESSING THE EFFECTS OF FLOATING EXCHANGE RATE REGIMES ON
INVESTMENT IN ETHIOPIA**

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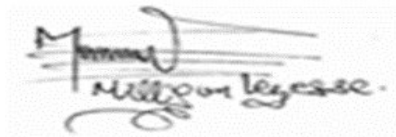
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Declaration

I, Milliyon Legesse, hereby declare that this thesis, titled “Assessing the Effect of Floating Exchange Rate Regimes on Investment in Ethiopia ” is my original work, prepared under the guidance of Mengistu Bogale, Ph.D. I acknowledge that all sourced materials utilized in the completion of this study have been properly cited. This thesis is submitted in partial fulfillment of the requirements for an MSc in Corporate Finance, specializing in Investment Management. I confirm that this work has not been submitted, in whole or in part, for any other institution's degree or examination.

Milliyon Legesse

A handwritten signature in black ink, appearing to read 'Milliyon Legesse', with a stylized flourish above the name.

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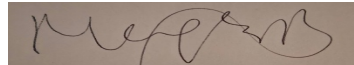
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Mengistu Bogale (Ph.D.)



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**ADDIS ABABA UNIVERSITY COLLEGE OF BUSSINESS AND ECONOMICS
SCHOOL OF COMMERCE**

**ASSESSING THE EFFECTS OF FLOATING EXCHANGE RATE REGIMES ON
INVESTMENT IN ETHIOPIA**

This is to certify that the thesis prepared by Milliyon Legesse, titled “Assessing the Effect of Floating Exchange Rate Regimes on Investment in Ethiopia ” has been submitted in partial fulfillment of the requirements for the Master’s degree in Corporate Finance, specializing in Investment Management. The thesis adheres to the university's regulations and accepted academic standards.

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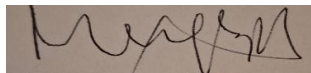
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ACRONYMS

AfDB	African Development Bank
CBN	Central Bank of Nigeria
CPI	Consumer Price Index
EEA	Ethiopian Economics Association
EIC	Ethiopian Investment Commission
ETB	Ethiopian Birr
FDI	Foreign Direct Investment
FX	Foreign Exchange
FY	Fiscal Year
GFCF	Gross Fixed Capital Formation
GTP	Growth and Transformation Plan
IBM SPSS	International Business Machines – Statistical Package for the Social Sciences
IMF	International Monetary Fund
NBE	National Bank of Ethiopia
OCA	Optimal Currency Area
SMEs	Small and Medium Enterprises
SPSS	Statistical Package for the Social Sciences
SSA	Sub-Saharan Africa
USD	United States Dollar
USD/Birr	United States Dollar to Ethiopian Birr Exchange Rate
WB	World Bank
WTO	World Trade Organization

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ABSTRACT

This research examines the effects of Ethiopia's transition to a floating exchange rate system in July 2024 on investment trends. A mixed-methods design integrates macroeconomic statistics from the NBE, IMF, and World Bank with sectoral data from the Ethiopian Investment Commission, supplemented by qualitative stakeholder perspectives. Foreign direct investment increased by 13.2% year-on-year, with EIC data indicating significant inflows into agro-processing and textiles, rising by 21.5% and 18.7%, respectively. Conversely, domestic investment contracted, as gross fixed capital formation decreased from 7.6% to 2.8%, influenced by increasing input expenses and exchange rate instability. Imported inflation reached a maximum of 31.8%, disproportionately impacting SMEs and import-reliant industries. The study suggests that in the absence of hedging mechanisms or focused policy interventions, Ethiopia's liberalized system may not achieve consistent, widespread investment benefits.

Key Words. Ethiopia, floating exchange rate, foreign direct investment, domestic investment, exchange rate volatility, competitive effects, uncertainty effect

CHAPTER ONE

1. Introduction

1.1 Background of the Study

Exchange rate regimes are a key aspect of macroeconomic governance because they determine how a country's currency is traded in global markets (Frankel, 2019). These systems span fixed arrangements in which the currency's value is firmly pegged to another currency or a basket, to flexible frameworks where rates fluctuate freely based on market forces (International Monetary Fund, 2024). The exchange rate regime a nation selects can have a substantial impact on crucial economic indicators, such as trade flows, inflation, and capital movements (Obstfeld & Rogoff, 1995).

The role of exchange rate regimes has become increasingly significant in economic policymaking as globalization deepens and financial markets become more interconnected. Fixed exchange rate systems provide stability by anchoring inflation expectations and mitigating uncertainty in currency valuations. (Calvo & Reinhart, 2002). However, they constrain a country's ability to respond to external shocks, such as sudden capital outflows or volatile commodity prices. (Edwards, 2012). Conversely, floating exchange rate frameworks offer flexibility in monetary policy, enabling countries to tailor economic responses to local conditions. (Rodrik, 2008). However, this flexibility comes at a cost, as floating regimes often result in heightened exchange rate volatility, which can disrupt financial markets and deter investment (Aizenman & Marion, 1999).

Ethiopia, a low-income, agriculture-dependent economy (contributing 35% of GDP and 80% of exports), has long used the exchange rate policy as a tool to balance stability and growth. The country's state-led industrialization strategy under the Growth and Transformation Plan (GTP) since the early 2000s prioritized infrastructure and manufacturing development, but it confronted structural hurdles, including chronic foreign exchange shortages and an underdeveloped private sector (National Bank of Ethiopia, 2023). In 2020, Ethiopia launched the Homegrown Economic Reform Agenda to liberalize key sectors, including finance and telecommunications, aiming to attract foreign investment and address macroeconomic imbalances (IMF, 2023). A core component of these reforms is the planned transition in July 2024 from a managed to a floating exchange rate regime, designed to enhance export competitiveness, improve foreign exchange allocation, and bolster resilience to external shocks (National Bank of Ethiopia, 2024).

The connection between flexible exchange rates and foreign direct investment is multifaceted. On one side, the adaptability of floating rates can lure foreign investors by making investments more affordable during periods of currency depreciation. On the other hand, the increased volatility linked to floating regimes can discourage FDI, particularly in long-term investment sectors, due

to heightened perceived risks (IMF, 2024). This duality highlights the relevance of the two theoretical perspectives in Ethiopia's context:

The Uncertainty Effect: Increased exchange rate volatility can elevate risk premiums, discouraging irreversible investments (Dixit & Pindyck, 1994). In the Ethiopian context, sectors reliant on imported inputs may delay capital expenditures due to unpredictable input costs. **The Competitiveness Effect:** Currency depreciation under floating exchange rate regimes can boost the competitiveness of export-oriented sectors but, conversely, harm import-dependent industries (Edwards, 2012). Ethiopia's export profile, dominated by low-value-added goods such as coffee and textiles, may limit the gains from depreciation, while importers face rising input costs.

Domestic investment is similarly affected by exchange rate fluctuations. Uncertainty surrounding input costs, particularly for industries dependent on imported goods and capital, may lead businesses to delay or scale back their investments (World Bank, 2018). Conversely, the enhanced competitiveness of export-oriented sectors such as agriculture and manufacturing under a flexible exchange rate system can stimulate domestic investment. However, Ethiopia's persistent inflation and shallow financial markets, which lack hedging instruments like forward contracts, amplify risks for businesses navigating the new regime (African Development Bank, 2024).

Understanding how Ethiopia's shift to a floating exchange rate affects investments is crucial. This study looks at how flexible exchange rates and their instability affect investment decisions, especially in agriculture and manufacturing, focusing on foreign investment and local capital growth. By considering Ethiopia's ongoing inflation, basic financial markets, and focus on low-value exports, this research aims to add real-world evidence to discussions on exchange rate policy in developing economies. While noting the broader effects of this policy change, the study concentrates on how it affects investment, providing useful information for policymakers and stakeholders in Ethiopia's changing economy.

1.2 Statement of the problem

Ethiopia's managed exchange rate regime has long served as a tool for providing short-term macroeconomic stability by curbing inflation and stabilizing external accounts. However, this system has significant limitations, particularly its inability to offer monetary policy flexibility. This rigidity has left Ethiopia vulnerable to external shocks, such as fluctuations in global commodity prices and volatile capital flows, which disrupt economic stability and hinder sustainable growth (World Bank, 2023). Recognizing these challenges, the National Bank of Ethiopia (NBE) initiated a major policy shift in July 2024, transitioning to a floating exchange rate regime to increase monetary policy autonomy, improve resilience to external shocks, and foster long-term economic development (IMF 2024).

While this transition holds potential benefits, it also presents significant risks and uncertainties, especially in an emerging economy like Ethiopia, which is characterized by structural weaknesses and underdeveloped financial markets. By design, floating exchange rates expose countries to

greater volatility in currency values, which can have profound effects on investment flows. On the one hand, the flexibility of a floating system can make domestic assets more attractive to foreign investors during periods of currency depreciation, potentially boosting foreign direct investment (FDI) (Rodrik, 2008). However, the same volatility increases uncertainty, which can deter long-term FDI, particularly in capital-intensive and infrastructure-heavy sectors where stability is critical (Aizenman & Marion, 1999).

Domestic investments also encounter comparable difficulties. Enterprises reliant on imported inputs and capital face uncertainty regarding input expenses due to exchange rate fluctuations, potentially prompting delayed investment decisions or curtailed expansion plans (Ghosh, Ostry, & Qureshi, 2015). Conversely, a floating exchange rate regime can enhance the competitiveness of export-oriented sectors such as agriculture and manufacturing, presenting growth opportunities if volatility is effectively managed (Edwards, 2012). However, in the Ethiopian context, persistent inflationary pressures, already a pressing concern, may be exacerbated by currency depreciation under a floating system, further complicating macroeconomic management and investment planning (African Development Bank 2024).

Moreover, there is limited research on how these dynamics play out in the unique context of emerging economies with underdeveloped financial systems, such as Ethiopia. Existing studies offer mixed evidence on the broader implications of floating exchange rate regimes for investment, with findings largely dependent on country-specific structural and institutional contexts (Calvo & Reinhart, 2002). This gap in knowledge highlights the need for a focused investigation of Ethiopia's experience, particularly as policymakers seek to balance the benefits of exchange rate flexibility with the risks of increased volatility.

This study addresses this critical gap by examining how Ethiopia's transition to a floating exchange rate regime affects both foreign direct investment and domestic investment flows. By doing so, this research will provide policymakers with actionable insights to optimize the benefits of the new regime while mitigating its risks, ensuring that the country's economic goals are achieved in a sustainable manner.

1.3 Research Questions

This study addresses the following research questions:

- How does Ethiopia's transition to a floating exchange rate regime influence foreign direct investment (FDI) flow?
- What are the effects of exchange rate volatility under a floating regime on domestic investment, particularly in key sectors such as agriculture and manufacturing?

1.4 General Objective

To examine the impact of Ethiopia's transition to a floating exchange rate regime on investment, focusing on both foreign direct investment (FDI) and domestic investment, and to identify strategies for managing volatility to enhance the investment climate.

Specific Objectives

- To evaluate the relationship between Ethiopia's floating exchange rate regime and FDI inflows.
- To assess the effects of exchange rate volatility on domestic investment, particularly in key sectors, such as agriculture and manufacturing.

1.5 Significance of the Study

This study examines how Ethiopia's shift to a floating exchange rate regime affects investment, offering insights into policy transitions relevant to many emerging economies with underdeveloped financial systems. By focusing on Ethiopia's unique context, including its structural challenges, such as forex shortages, reliance on agriculture and manufacturing exports, and nascent financial markets. This study addresses a gap in the existing literature that often overlooks the interplay between exchange rate flexibility and investment in low-income economies.

For Ethiopian businesses and investors, the findings may help identify practical strategies for managing risks linked to currency volatility, particularly for sectors dependent on exports or imported inputs. The study can also inform foreign investors regarding the assessment of opportunities in Ethiopia's evolving economic landscape.

For policymakers, this research provides evidence to refine exchange rate management strategies by balancing the potential benefits of flexibility (e.g., export competitiveness) with measures to stabilize domestic investment and mitigate volatility. This is particularly timely, as Ethiopia seeks to attract foreign direct investment (FDI) and sustain growth during macroeconomic uncertainty.

Academically, this study contributes to discussions on exchange rate regimes in developing economies by challenging assumptions derived from more stable or advanced markets. Analyzing Ethiopia's experiences enriches the limited empirical research on sub-Saharan African economies and encourages comparative studies in similar contexts.

Finally, this research invites further exploration of sector-specific investment responses to exchange rate fluctuations and the long-term effects of floating regimes on economic transformation. While focusing on Ethiopia, the findings may offer lessons for other low-income countries considering exchange rate liberalization.

1.6 Scope of the Study

This study focuses on Ethiopia's transition to a floating exchange rate regime and its effects on investment. This study examines the period surrounding the implementation of the floating regime, which was introduced into law in July 2024, with an emphasis on both FDI and domestic investment across key sectors, including agriculture, manufacturing, and tradable goods. Although this study primarily focuses on Ethiopia, its findings may offer relevant insights for other emerging economies.

1.7 Limitations and Delimitations

this study has a few limitations that may affect the interpretation of the findings.

Data Availability and Quality

- Reliable, high-frequency data on Ethiopia's economic performance after transitioning to a floating exchange rate regime are limited. This study relies on secondary data sources, such as government reports and international organization datasets, which may introduce inconsistencies or biases.

Literature limitation:

- While Ethiopia provides a valuable case study, its unique economic structure is characterized by heavy reliance on agriculture, state-led industrialization, and limited financial market development. This may limit the generalizability of some studies.

Methodological Constraints

- The analysis is constrained by the availability of the granular data needed for advanced econometric modeling, which may limit the ability to fully capture the impact of exchange rate volatility on investment flows.

These limitations are acknowledged to ensure transparency and highlight areas for further research. Despite these constraints, this study provides valuable insights into the effects of floating exchange rate regimes on Ethiopian investment dynamics.

1.8 Structure of the Thesis

This thesis is organized into five chapters to systematically explore Ethiopia's transition to a floating exchange rate regime and its impact on investment. The first chapter provides an insightful introduction, setting the context with a detailed background of exchange rate regimes and Ethiopia's economic transformation. This defines the research problem, objectives, and significance, framing the study of the interaction between exchange rate volatility and investments. Chapter 2 reviews the theoretical and empirical literature, including the conceptual framework upon which the two are built, synthesizing insights into the benefits and trade-offs of floating exchange rate systems while identifying gaps relevant to Ethiopia's unique economic climate.

Chapter 3 outlines the research methodology, detailing the data sources, research design, and analytical techniques, while addressing challenges such as data limitations and ensuring methodological rigor. Chapter 4 presents the findings, analyzing trends in foreign direct investment (FDI), domestic investment, and the effects of exchange rate volatility on investment flows. Finally, Chapter Five summarizes the key results, discusses their implications for policymakers and stakeholders, and offers directions for future research. Together, these chapters' weave theory, analysis, and insights into a comprehensive narrative that highlights the complexities of exchange rate volatility and investment in Ethiopia.

CHAPTER TWO

Literature Reviews

Theoretical and Empirical Perspectives on Exchange Rate Regimes and Investment

This chapter critically reviews both theoretical perspectives and empirical evidence concerning the relationship between exchange rate regimes and investment, with particular emphasis on developing economies and Ethiopia's unique context. The literature underscores the complex trade-offs between stability and flexibility, the channels through which exchange rate regimes influence investment, and the specific outcomes observed in Sub-Saharan Africa. The chapter concludes by highlighting existing research gaps and the intended contribution of the present study.

2.1 Theoretical Foundations of Exchange Rate Regimes

Exchange rate regimes are a fundamental component of macroeconomic management, profoundly shaping trade flows, inflation dynamics, and investment decisions. Fixed exchange rate regimes, where the domestic currency is pegged to another currency or a basket of currencies, are often favored for their ability to provide nominal stability, reduce transaction costs, and mitigate uncertainty in international trade and investment (Frankel, 2019). In contrast, floating exchange rate regimes grant market forces the autonomy to determine currency values. These regimes offer greater flexibility in responding to external shocks, but this flexibility often comes at the cost of short-term volatility, which can discourage investment and destabilize prices, especially in economies with less developed financial systems (IMF, 2024).

The optimal choice of exchange rate regime depends on specific structural and economic conditions, as articulated by Robert Mundell's Optimal Currency Area (OCA) theory. According to Mundell (1961), fixed exchange rate regimes are more suitable for countries that exhibit high levels of trade integration, synchronized economic cycles, and labor mobility. In contrast, economies that face asymmetric shocks or have fragmented structures benefit more from floating exchange rates, as these allow for autonomous monetary adjustments to maintain external balance.

One of the most prominent theoretical frameworks linking exchange rate regimes to investment is the uncertainty channel. As described in the real options theory by Dixit and Pindyck (1994), the presence of exchange rate volatility significantly raises the risk premium associated with irreversible investments. In such environments, firms often adopt a "wait and see" approach, deferring long-term investments due to the high opportunity cost of making premature commitments. This effect is especially pronounced in infrastructure and other capital-intensive sectors where investment horizons are long and returns are sensitive to macroeconomic stability. Extending this framework, Aizenman and Marion (1999) empirically demonstrated that foreign direct investment (FDI) in long-gestation sectors declines by approximately 15–20% in environments characterized by high exchange rate volatility. Their findings suggest that investors

exhibit strong preferences for macroeconomic predictability, particularly in sectors where returns materialize over extended periods.

Another important mechanism is the competitiveness channel, through which exchange rate regimes influence relative prices and trade performance. Floating regimes that allow for currency depreciation can enhance export competitiveness by lowering the foreign currency price of domestically produced goods. Edwards (2012) notes that this effect can be particularly beneficial for export-oriented sectors such as agriculture, where price sensitivity in global markets is high. However, depreciation also raises the cost of imports, leading to adverse effects in import-intensive industries. Obstfeld and Rogoff (1995) introduced the concept of the J-curve effect, suggesting that while depreciation may eventually improve the trade balance by boosting exports, it typically leads to an initial deterioration. This is because import payments tend to rise faster than export volumes adjust, resulting in a temporary worsening of the current account especially problematic for economies heavily reliant on imported inputs.

The so-called “impossible trinity” or policy trilemma further complicates the selection of an optimal exchange rate regime. As articulated by Obstfeld and Rogoff (1995), no country can simultaneously maintain a fixed exchange rate, allow free capital movement, and conduct an independent monetary policy. Floating exchange rate regimes theoretically resolve this conflict by granting central banks the autonomy to prioritize domestic objectives such as inflation targeting or employment growth. However, Calvo and Reinhart (2002) argue that many developing economies suffer from a “fear of floating,” wherein governments, despite nominally flexible regimes, routinely intervene in currency markets to suppress volatility. Such interventions often compromise the credibility of monetary policy and blur the intended benefits of regime flexibility.

2.2 Empirical Evidence on Exchange Rate Regimes and Investment

Empirical studies present a mixed picture of the relationship between exchange rate regimes and investment flows, particularly FDI. On a global scale, Rodrik (2008) finds that flexible exchange rate arrangements are often associated with increased FDI inflows, as they align currency values more closely with underlying economic fundamentals. Such alignment reduces the risk of over- or undervaluation, thereby improving allocative efficiency. Similarly, the IMF (2024) reports a notable 12% increase in FDI among emerging markets following the liberalization of their exchange rate regimes. These findings suggest that floating regimes can enhance investor confidence when accompanied by credible macroeconomic frameworks.

However, not all evidence is supportive of floating regimes. Aizenman and Marion (1999) document that in parts of Latin America, the volatility introduced by floating exchange rates had a chilling effect on investment. In particular, manufacturing sectors characterized by high input costs and limited hedging capacity experienced stagnant or declining FDI levels. This underscores the importance of complementary institutional features, such as financial depth and policy credibility, in determining the success of floating regimes.

Divergent outcomes are also evident among developing countries. For example, Argentina's post-2002 experience shows a 40% increase in FDI, particularly in commodity-exporting sectors such as soybeans and minerals, driven by a highly competitive exchange rate. Yet, the same period witnessed a decline in manufacturing investment, largely due to input price volatility and persistent macroeconomic uncertainty (Calvo & Reinhart, 2002). Thailand's adoption of a managed float following the 1997 Asian financial crisis led to a surge in FDI in the electronics sector, which grew by 15% annually. Nonetheless, small and medium enterprises (SMEs) in the country struggled with the cost and complexity of hedging against currency risks, limiting their competitiveness (Ghosh et al., 2015).

Egypt's 2016 move to a floating exchange rate regime produced similarly mixed results. The hydrocarbons sector experienced a 25% increase in FDI due to the improved repatriation environment and the devaluation of the Egyptian pound. However, the float triggered rapid inflation, which reached 40% in 2017 and eroded the purchasing power of domestic firms, particularly those in the SME sector that were heavily reliant on imported inputs (IMF, 2023). These contrasting sectoral outcomes emphasize the importance of structural characteristics such as import dependency, access to credit, and hedging availability in mediating the effects of exchange rate policy.

The sector-specific effects of exchange rate regimes are further illustrated in Sub-Saharan African economies. In Kenya, for instance, a 10% depreciation of the shilling led to an 8% increase in tea exports, demonstrating the benefits of currency flexibility for export agriculture. However, the same depreciation raised fertilizer costs by 15%, severely impacting smallholder farmers and reducing net gains (Edwards, 2012). Similarly, in Nigeria, the 2016 Naira depreciation boosted textile exports by 10%, but manufacturing costs surged by 25% due to higher import prices, undermining profitability (CBN, 2020). Egypt's automotive industry also experienced a 15% reduction in investment following the 2016 float, as the cost of importing inputs skyrocketed (World Bank, 2023). These cases confirm that while floating regimes can enhance export competitiveness, their success depends on a country's import dependency and institutional capacity to manage volatility.

2.3 Exchange Rate Regimes in Sub-Saharan Africa

Sub-Saharan Africa (SSA) presents a particularly challenging environment for floating exchange rate regimes due to its structural characteristics. Many economies in the region rely heavily on commodity exports, have shallow financial systems, and face persistent external imbalances. In Nigeria, the partial float of the naira in 2016 improved foreign exchange liquidity and eased pressure in the oil sector. However, non-oil FDI failed to materialize, and manufacturing investment declined by 20% due to continuing exchange rate volatility and inadequate risk mitigation instruments (CBN, 2020). Similarly, Zambia's liberalization of its exchange rate regime in 2020 resulted in a 50% depreciation of the kwacha. This discouraged mining sector investment, largely due to unhedged risks and the absence of robust financial instruments (AfDB, 2023).

Kenya's long-standing managed float has had mixed outcomes. While the regime has helped stabilize foreign exchange reserves and limit excessive short-term volatility, it has also contributed to the overvaluation of the Kenyan shilling by an estimated 10–15% which has undermined the competitiveness of horticulture exports (IMF, 2022). Across the region, broader challenges such as dollarization (e.g., Zimbabwe, where over 70% of transactions are in U.S. dollars), weak monetary institutions, and limited access to risk mitigation tools exacerbate the negative effects of volatility (IMF, 2023). These structural barriers suggest that the success of floating regimes in SSA is conditional on deepening financial markets, diversifying exports, and strengthening institutional frameworks.

2.3.1 Historical Evolution of Ethiopia's Exchange Rate Regime

The development of Ethiopia's exchange rate regime reflects broader political, ideological, and institutional transformations that have shaped the country's macroeconomic trajectory over the last century. This historical overview provides critical context for understanding the current policy shift toward exchange rate liberalization in 2024 and its potential investment implications.

Imperial Era and Early Currency Regime (Pre-1974)

During the reign of Emperor Haile Selassie, Ethiopia operated under a fixed exchange rate system, with the birr (initially referred to as the Ethiopian dollar) pegged to the US dollar, and later, to a basket of currencies through the International Monetary Fund's (IMF) Special Drawing Rights (SDRs). This era was characterized by a conservative monetary approach, aimed at promoting trade stability and insulating the domestic economy from external shocks (Geda, 2006). Although Ethiopia maintained relative price stability, the country's limited integration into global capital markets and its low level of industrialization meant that the exchange rate system served primarily as a nominal anchor rather than a tool for competitiveness or investment promotion.

The Derg Regime: Central Planning and Currency Distortions (1974–1991)

The overthrow of the imperial government in 1974 ushered in a Marxist-Leninist military junta known as the Derg, which implemented a centrally planned economic model. Under this regime, Ethiopia adopted a rigidly fixed exchange rate system, with the birr maintained at artificially high levels. The exchange rate was used primarily as an administrative tool rather than a market-based policy instrument, resulting in severe misalignments between the official and market rates. A substantial black-market premium emerged during this period, often exceeding 100%, reflecting unmet foreign exchange demand and inefficient allocation of currency resources (Elbadawi & Gelb, 1992). Capital controls, import licensing, and state monopolies over major sectors effectively suppressed private investment and foreign capital inflows.

Post-Derg Liberalization and the Shift to Managed Float (1991–2000)

Following the fall of the Derg in 1991, the newly formed Ethiopian People's Revolutionary Democratic Front (EPRDF) embraced market-oriented reforms under the guidance of the IMF and World Bank's Structural Adjustment Programs (SAPs). One of the key reforms was the gradual devaluation of the birr and the introduction of a managed floating exchange rate regime. Between 1992 and 2000, the birr depreciated from 2.07 to nearly 8 birr/USD (Geda, 2006; IMF, 2001). This policy shift aimed to realign the exchange rate with market fundamentals, reduce the black-market premium, and encourage export competitiveness.

However, the regime retained a significant degree of administrative control. Foreign exchange surrender requirements, import prioritization, and a lack of capital account liberalization meant that the exchange rate continued to be tightly managed. Despite modest improvements in export performance, the investment climate remained constrained by institutional weaknesses, limited financial liberalization, and political uncertainty.

Developmental State Model and Currency Misalignment (2001–2018)

Between 2001 and 2018, Ethiopia pursued a developmental state model, characterized by large-scale public investment in infrastructure, manufacturing, and agriculture through its Growth and Transformation Plans (GTP I & II). The exchange rate policy during this period remained a controlled float, with frequent discrete devaluations rather than continuous adjustments based on market demand and supply (World Bank, 2016). While devaluations aimed to support export growth and narrow the trade deficit, they often lagged behind inflation, resulting in sustained real exchange rate overvaluation.

Persistent foreign exchange shortages and a burgeoning black-market premium (ranging from 20–35%) signaled significant structural distortions. The National Bank of Ethiopia (NBE) allocated foreign exchange through an administrative system, prioritizing government-aligned infrastructure and manufacturing projects. As a result, private firms and import-dependent sectors struggled to access foreign currency, limiting private investment and fueling capital misallocation (NBE, 2018; IMF, 2019).

The Homegrown Economic Reform Agenda and Exchange Rate Liberalization (2019–2024)

In response to mounting external imbalances and inefficiencies in foreign exchange allocation, the government launched the Homegrown Economic Reform Agenda in 2019, with support from the IMF and other development partners. The reforms sought to improve macroeconomic management by liberalizing the foreign exchange regime, strengthening monetary policy, and reducing the role of state-led resource allocation.

A landmark component of this agenda was the transition to a floating exchange rate regime in 2024, ending decades of heavy central bank intervention in currency markets. This move was intended to improve exchange rate transparency, eliminate the parallel market, attract foreign direct investment, and enhance resource allocation efficiency. The IMF (2024) projected that the float would help address the country's chronic forex shortages and boost external competitiveness. However, early indicators pointed to heightened short-term volatility, currency depreciation, and import-driven inflation, particularly affecting sectors reliant on imported inputs such as pharmaceuticals, manufacturing, and agribusiness.

The liberalization also occurred in a context of weak financial market infrastructure. Ethiopia lacks derivative instruments, forward contracts, or currency hedging tools—essential instruments for managing exchange rate risk in a floating system. This institutional gap means that the benefits of liberalization may be muted or delayed unless accompanied by reforms to deepen financial markets and strengthen monetary institutions (AfDB, 2024; World Bank, 2023).

Synthesis of Historical Evolution

Over the past five decades, Ethiopia's exchange rate regime has transitioned from fixed and administratively managed systems to a market-based floating regime, albeit with significant structural constraints. While each regime shift was prompted by macroeconomic challenges—ranging from trade imbalances to inflation and currency shortages—most policy frameworks have struggled to strike a sustainable balance between stability and competitiveness. Historical evidence suggests that exchange rate reforms, in isolation, are insufficient to attract investment or improve allocative efficiency without concurrent development of financial markets, diversification of exports, and policy credibility.

2.4 Ethiopia's Context and Research Gaps

Ethiopia provides a compelling case study in the evolution of exchange rate regimes in a structurally constrained low-income country. Prior to 2024, the country maintained a tightly managed exchange rate system aimed at controlling inflation and supporting state-led industrialization through the Growth and Transformation Plan (GTP). While this policy framework provided short-term stability, it led to chronic foreign exchange shortages, widened the black-market premium, which reached 30% and limited the allocative efficiency of foreign currency resources (NBE, 2023). These distortions inhibited private-sector growth and undermined the competitiveness of Ethiopian exports (World Bank, 2023).

In 2024, Ethiopia transitioned to a floating exchange rate regime under the broader Homegrown Economic Reform Agenda. The IMF has projected that this policy shift will improve foreign exchange liquidity and attract FDI. Nevertheless, the African Development Bank (2024) warns that without adequate safeguards, the move could trigger inflationary pressures and exacerbate import constraints. Ethiopia's structural characteristics, such as its low export diversification,

where over 80% of export earnings derive from a narrow range of primary goods, limit its ability to benefit from depreciation-driven competitiveness gains (NBE, 2023).

Further compounding these challenges is the underdevelopment of Ethiopia's financial markets. The country lacks derivative instruments and hedging mechanisms, leaving investors highly exposed to exchange rate risk. Moreover, the financial sector remains heavily state-dominated, with public banks accounting for over 80% of credit provision, which distorts foreign currency allocation and limits financial innovation (World Bank, 2023).

Despite these significant shifts in policy and structure, academic literature on Ethiopia's exchange rate regime remains sparse. No empirical studies have yet examined the sector-specific investment effects of the 2024 float, nor have scholars' proposed concrete strategies to manage exchange rate volatility in such a low-capacity environment. This absence of empirical inquiry underscores the need for further research tailored to Ethiopia's institutional and economic realities.

2.5 Synthesis and Contribution

This review underscores a fundamental gap between the theoretical benefits of exchange rate flexibility and the practical constraints faced by low-income and structurally fragile economies. While floating regimes promise improved competitiveness, greater policy autonomy, and more efficient resource allocation, their success hinges on the presence of deep financial markets, diversified export bases, and strong institutional frameworks conditions often absent in countries like Ethiopia.

The Ethiopian case exemplifies the risks and rewards of exchange rate liberalization in low-income settings. The literature reveals important lessons from other developing countries, yet the specific context of Ethiopia marked by state dominance in finance, narrow export composition, and limited policy instruments remains underexplored. Addressing this gap, the current study aims to evaluate the effects of Ethiopia's 2024 exchange rate liberalization on foreign and domestic investment across key sectors while proposing practical policy instruments to mitigate volatility. In doing so, it seeks to bridge the gap between global exchange rate theory and the empirical realities of exchange rate management in low-capacity environments.

2.6 Conceptual Framework on Exchange Rate Liberalization and Investment in Ethiopia

Drawing on the theoretical and empirical foundations reviewed in the preceding sections; this study proposes a refined conceptual framework to analyze Ethiopia's transition to a floating exchange rate regime in 2024 and its potential implications for investment. The framework centers on two principal transmission channels the uncertainty channel and the competitiveness channel through which exchange rate flexibility influences both foreign and domestic investment. These channels are moderated by a constellation of structural characteristics that are distinctive to Ethiopia's low-income and financially shallow economy. The framework synthesizes established theoretical models, comparative empirical evidence, and context-specific economic constraints to guide the study's analytical approach.

The conceptual framework presented in Figure 2.1 is adapted from established theoretical models of exchange rate regimes and investment behavior, notably the uncertainty channel (Dixit & Pindyck, 1994; Aizenman & Marion, 1999) and the competitiveness channel (Edwards, 2012; Obstfeld & Rogoff, 1995), and is contextualized to Ethiopia's unique structural and institutional landscape.

The first and more immediate mechanism is the uncertainty channel, which captures the adverse impact of exchange rate volatility on investment behavior. As Ethiopia moves from a tightly managed exchange rate regime to a market-determined system, it is expected that the birr will experience heightened short-term volatility. This dynamic is consistent with the findings of Frankel (2019), who notes that exchange rate liberalization typically elevates macroeconomic unpredictability, particularly in economies lacking the institutional infrastructure to smooth fluctuations. According to the real options framework articulated by Dixit and Pindyck (1994), such volatility raises the opportunity cost of irreversible investments, incentivizing firms to delay capital commitments in favor of a “wait-and-see” approach. This effect is especially pronounced in sectors characterized by long gestation periods and sunk costs, such as textiles.

Empirical studies further substantiate the theoretical linkage between volatility and investment suppression. Aizenman and Marion (1999), for instance, demonstrate that foreign direct investment in long-horizon sectors declines by up to 20% in environments marked by high exchange rate uncertainty. In the case of Ethiopia, this channel is amplified by the absence of forward markets, hedging instruments, or accessible derivatives, which forces investors to internalize the full spectrum of currency risk. Moreover, the shallow depth of Ethiopia's financial system still largely state-dominated and credit-constrained limits the availability of long-term finance, exacerbating the deterrent effect of volatility. In this context the standard deviation of the official Birr/USD rate serves as a key proxy for macro-financial uncertainty, capturing the actual currency instability.

The second mechanism embedded within the framework is the competitiveness channel, which captures the dual-edged implications of exchange rate depreciation for export and import dynamics. In theory, a depreciating currency enhances the price competitiveness of a country's exports by lowering their foreign currency valuation, thereby stimulating demand and attracting export-oriented foreign investment. Edwards (2012) emphasizes this advantage in price-sensitive global markets such as agricultural commodities and light manufacturing. In Ethiopia's case, sectors like coffee, leather, and textiles could stand to benefit from enhanced global competitiveness under a more flexible exchange rate regime.

However, as outlined in Obstfeld and Rogoff's (1995) exposition of the J-curve effect, the positive effects of depreciation are often delayed and may be outweighed in the short term by a sharp rise in import costs. This is particularly problematic for countries like Ethiopia, where the production structure is heavily reliant on imported capital and intermediate goods. In agriculture, for instance, fertilizers, pesticides, and fuel all denominated in foreign currency constitute a substantial portion

of input costs. Similarly, manufacturing industries dependent on imported machinery, chemicals, and raw materials face rising production costs that erode profitability. The net effect, as documented in post-float experiences in countries such as Egypt and Nigeria (World Bank, 2023; CBN, 2020), is often a sectoral divergence: export-oriented industries experience investment gains, while import-dependent sectors confront shrinking margins and stagnant capital formation.

These two primary channels uncertainty and competitiveness do not operate in isolation. Their influence is significantly conditioned by a set of structural moderators that define the Ethiopian macroeconomic context. The first among these is the thinness of financial markets, which deprives investors of tools to manage exchange rate risks. As Aizenman and Marion (1999) note, the absence of hedging mechanisms disproportionately impacts long-horizon and capital-intensive investments. Second, Ethiopia's concentration of exports in primary commodities over 80% of which are composed of coffee, gold, and horticulture limits the scope for broad-based competitiveness gains, thereby muting the potential upside of depreciation. Third, the country's heavy import dependency transforms nominal depreciation into imported inflation, which in turn reduces real returns on investment. Finally, the credibility of monetary and exchange rate policy plays a decisive role. As Calvo and Reinhart (2002) argue, many developing countries adopt a floating regime in name but engage in frequent interventions to suppress volatility a phenomenon termed "fear of floating." Such inconsistencies often undermine investor confidence and obscure the signal value of policy adjustments.

The impact of these interacting channels and constraints varies markedly across sectors. In agriculture, for instance, commercial-scale farms that produce for export markets may benefit from depreciation-induced competitiveness. However, smallholder farmers who constitute the majority are likely to experience adverse effects due to increased costs of fertilizer and fuel, echoing Kenya's experience in the tea sector following currency devaluation (Edwards, 2012). In manufacturing, sectors such as textiles and leather may attract foreign investment owing to their export orientation, but their profitability remains vulnerable to cost surges in imported inputs. Conversely, industries such as pharmaceuticals and automotive assembly highly dependent on foreign intermediate goods face compressed profit margins and investment attrition. These sectoral outcomes align with the experiences of Egypt and Nigeria, where FDI was concentrated in resource-extractive or exportable sectors post-float, while import-reliant industries suffered substantial declines (IMF, 2023; CBN, 2020).

The role of policy credibility constitutes a final and overarching mediating factor in this framework. Where central banks maintain transparent, rule-based monetary frameworks such as inflation targeting and intervene strategically rather than arbitrarily in currency markets, the transition to a floating regime can improve macroeconomic stability and attract long-term investment. Thailand's post-crisis experience is instructive in this regard, demonstrating that credible monetary policy can temper the adverse effects of floating exchange rates. However, in the absence of policy clarity and consistency, as observed in Egypt and several sub-Saharan

African countries, floating regimes often fail to deliver their theoretical benefits and may even destabilize investor expectations.

In sum, this conceptual framework operationalizes the dual transmission effects of a floating exchange rate regime on investment in Ethiopia while embedding structural moderators and policy contingencies that shape its sectoral manifestations. It offers a dynamic lens through which to interpret the early outcomes of the 2024 liberalization, drawing on robust theoretical models, cross-country empirical evidence, and Ethiopia’s unique macroeconomic constraints. The framework serves not only as an analytical foundation for this study but also as a policy-relevant model for assessing exchange rate regime transitions in similarly structured low-income economies.

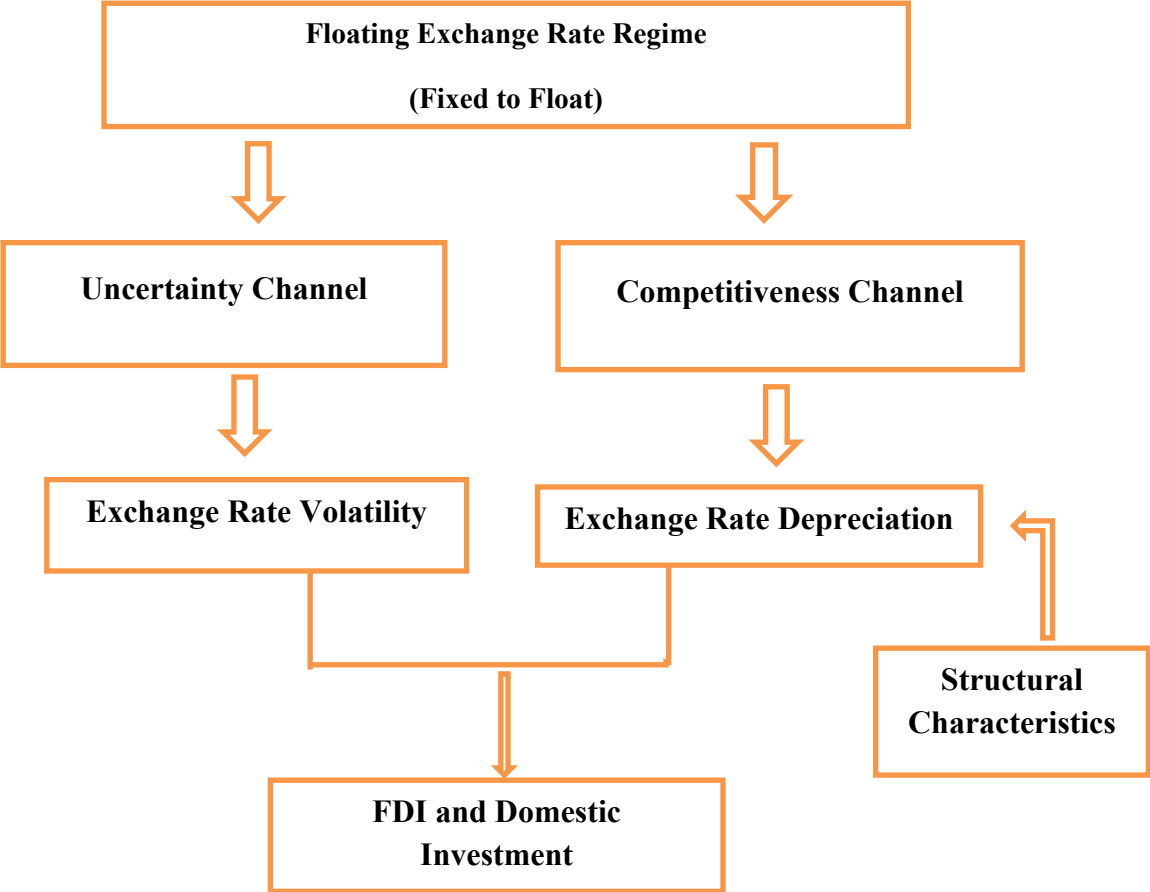


Figure 2.1: Conceptual Framework on Exchange Rate Liberalization and Investment in Ethiopia

CHAPTER THREE

Research Methodology

3.1 Research Design

This study adopted a descriptive research design to systematically examine the relationship between exchange rate volatility introduced by Ethiopia's transition to a floating exchange rate regime and observable shifts in investment behavior. Rather than limiting itself to broad generalizations, the study aimed to present an accurate and detailed account of how macroeconomic disruptions influenced investment flows across sectors, distinguishing between foreign and domestic responses. The descriptive approach was particularly well-suited to this inquiry, as it allowed the researcher to highlight not only what changes were occurring but also how they manifested under given structural conditions. Drawing from both statistical evidence and stakeholder insights, the design supported a careful evaluation of Ethiopia's 2024 policy shift during its critical early phase.

3.2 Research Approach

To capture both the measurable and experiential dimensions of investment behavior under the new regime, the study employed a mixed-methods approach. This approach combined the empirical rigor of quantitative analysis with the contextual richness of qualitative inquiry. The integration of these methods allowed for triangulation of findings, enhancing both validity and depth.

The quantitative component of the study focused on secondary data analysis. It examined trends in foreign direct investment (FDI) and domestic capital formation before and after the exchange rate reform. These investment flows were analyzed in relation to variables such as exchange rate movements, inflation, and macroeconomic indicators, using data from reputable national and international sources.

The qualitative component complemented the statistical analysis by exploring the perceptions and responses of key stakeholders. Through semi-structured interviews, the study engaged with financial analysts, policymakers, and sectoral actors to understand how exchange rate volatility had influenced their decisions, expectations, and risk management strategies. This interpretive layer added a human dimension to the numbers, clarifying the mechanisms through which macroeconomic policy affected behavior on the ground.

Together, these approaches provided a holistic understanding of how exchange rate liberalization had begun to reshape Ethiopia's investment environment in the short term. The methodology reflected the study's commitment to capturing not only structural outcomes but also the lived realities of reform in a low-income, financially constrained setting.

3.3 Data Collection

3.3.1 Sources of Data

To ensure analytical robustness, the study drew on both secondary and primary data sources.

Secondary Data (Quantitative):

The quantitative analysis relied on macroeconomic and sectoral data drawn from:

- The National Bank of Ethiopia (NBE), which provided historical exchange rate figures and monetary policy updates.
- The World Bank and International Monetary Fund (IMF), which offered data on FDI flows, inflation rates, capital movement, and other macroeconomic indicators.
- Official government reports and sectoral publications, especially those related to agriculture, manufacturing, and investment performance across critical industries.

Primary Data (Qualitative):

For the qualitative component, data were gathered through semi-structured interviews with purposefully selected stakeholders. These included:

- Financial analysts with expertise in investment risk and economic forecasting in Ethiopia.
- Policymakers, particularly from the National Bank of Ethiopia and relevant government ministries involved in exchange rate and monetary policy formulation.
- Industry representatives, especially from sectors most sensitive to currency fluctuations, such as export agriculture, textiles, and import-dependent manufacturing.

This combination of macro-level data and micro-level perspectives ensured that the study captured both objective economic trends and the subjective responses they provoked.

3.3.2 Sampling Strategy

Quantitative Sampling:

A purposive sampling method was used to isolate datasets that reflected conditions immediately before and after Ethiopia's transition to a floating regime. The sample period included:

- A three-year pre-transition window (July 2021–June 2024), establishing a historical baseline.
- A one-year post-transition window (July 2024–March 2025), capturing early investment reactions to the new exchange rate environment.

This time frame balanced the need for comparative analysis with the limited data availability characteristic of recent policy shifts.

Qualitative Sampling:

A targeted group of 8 to 10 key informants were interviewed, selected for their relevance to the research questions and diversity of perspectives. The sample included:

- Public officials involved in monetary and exchange rate policy,
- Academic and professional economists with a specialization in macroeconomic policy, and
- Private sector investors and business leaders from vulnerable or high-potential sectors.

Efforts were made to ensure diversity in sectoral representation and to avoid overrepresentation from any single stakeholder group.

3.4 Data Analysis

3.4.1 Quantitative Analysis

The quantitative analysis involves both descriptive and inferential statistical techniques.

- **Descriptive statistics** will be used to summarize and visualize trends in FDI inflows, domestic capital formation, and exchange rate movements during the study period. Techniques include time-series plots, percentage change calculations, and rolling averages.

Given the relatively short post-transition window, the primary aim of the regression model is to detect short-term associations and directional shifts rather than to make long-term forecasts. The data analysis will be conducted using **SPSS** and **Microsoft Excel**, based on the complexity of the model and the availability of structured datasets.

3.4.2 Qualitative Analysis

Thematic analysis was used to interpret interview transcripts. This method identified recurring ideas, sentiments, and viewpoints across different stakeholders and groups.

Key themes included:

- Perceptions of currency volatility and macroeconomic risk,
- Reported changes in investment behavior and decision-making,
- Sector-specific concerns and adaptation strategies, and
- Views on the consistency, clarity, and credibility of policy measures introduced during and after the float.

Themes were systematically coded and organized to ensure that findings were anchored in the data while supporting broader theoretical interpretations. This qualitative layer enriched the statistical analysis by revealing the human considerations that underlay economic choices.

3.5 Research Delimitations

As with any empirical inquiry, this study is subject to limitations:

1. **Temporal Scope**

The research is limited to the first-year post-float (2024–2025). While this focus captures immediate impacts, it does not allow for long-term trend analysis or the study of lagged investment responses.

2. **Contextual Specificity**

the findings are shaped by Ethiopia’s unique economic conditions including its narrow export base, dependence on imported inputs, and underdeveloped financial markets. These characteristics may limit the applicability of results to other developing economies without similar structural constraints.

3.6 Ethical Considerations

The study adheres to high standards of ethical integrity throughout the research process.

- **Ethical Approval:** Prior to initiating data collection, ethical clearance will be obtained from the relevant university or institutional ethics board.
- **Informed Consent:** All participants in the qualitative interviews will be fully briefed on the purpose of the study. Written informed consent will be obtained before participation.
- **Confidentiality and Anonymity:** Participants' identities will be protected through anonymization. Interview data will be handled confidentially and will not be linked to any identifiable personal or organizational information.
- **Data Protection:** All data will be stored securely in encrypted digital formats and accessed only by authorized researchers. The study will comply with data protection laws and institutional data management guidelines.

CHAPTER FOUR: RESULTS AND DISCUSSION

4.1 Introduction to the Chapter

This chapter presents and discusses the empirical findings of the study, examining the early effects of Ethiopia's transition to a floating exchange rate regime (July 2024) on investment flows. Aligned with the specific objectives, it analyzes trends in Foreign Direct Investment (FDI), assesses the impact on domestic investment (particularly in agriculture and manufacturing), and explores stakeholder perspectives on managing volatility. The analysis integrates quantitative data (secondary sources) with qualitative insights (stakeholder interviews) to provide a nuanced understanding of the dynamics at play during the first-year post-float (July 2024–June 2025). Findings are interpreted through the conceptual lens of the Uncertainty Channel and Competitiveness Channel, moderated by Ethiopia's unique structural characteristics.

4.2 Descriptive Analysis of Post-Float Exchange Rate Dynamics

The transition to a floating birr in July 2024 marked a significant departure from the managed regime. Key trends emerged:

Depreciation & Volatility: The birr experienced a sharp initial depreciation of approximately 60% against the USD within the first three months, from 54 ETB/USD to 85-90 ETB/USD. Subsequently, volatility increased markedly. The standard deviation of monthly exchange rates rose to 5.2 ETB post-float, compared to 0.8 ETB during the managed period (July 2021-June 2024), a clear indicator of heightened uncertainty (Figure 4.1). According to the NBE (2023), the black-market premium was estimated at approximately 30%. While the 2025 figures are not yet officially published, the IMF (2024) acknowledged that reforms, including the adoption of a flexible exchange rate regime, were expected to significantly narrow the parallel market premium.

Inflationary Pressure: As predicted by the conceptual framework, depreciation fueled imported inflation. CPI inflation accelerated from a pre-float average of approximately 19.2% to a peak of 31.8% in Q4 2024 before moderating slightly to 14.4% by April 2025 (Figure 4.2). This surge significantly eroded real incomes and investment returns, particularly for urban wage earners and savers relying on fixed-income assets.

Foreign Exchange Reserves: Early data suggested a modest improvement in gross FX reserves, rising from \$1.5 billion in 2023 to approximately \$2.1 billion by Q1 2025, partly attributed to improved allocation under the float and potential short-term capital inflows attracted by high interest rates. However, reserves remained below adequacy thresholds, typically set at 3 months of import cover, according to IMF (2024) guidelines.

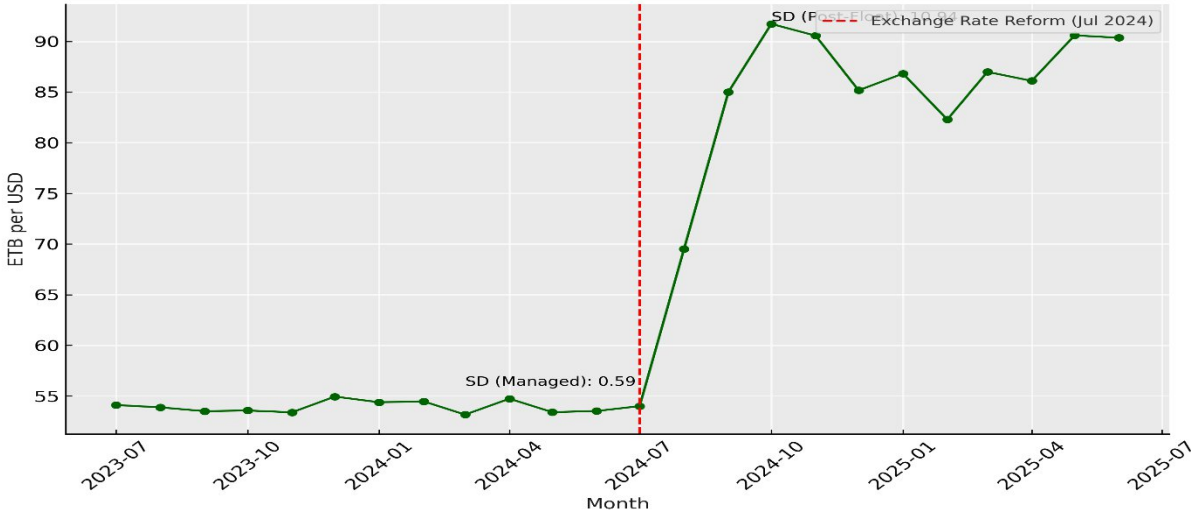


Figure 4.1: Nominal ETB/USD Exchange Rate and Volatility (Rolling Std. Dev.), Pre- and Post-Float

Source: Researcher’s own construct using IBM SPSS 25

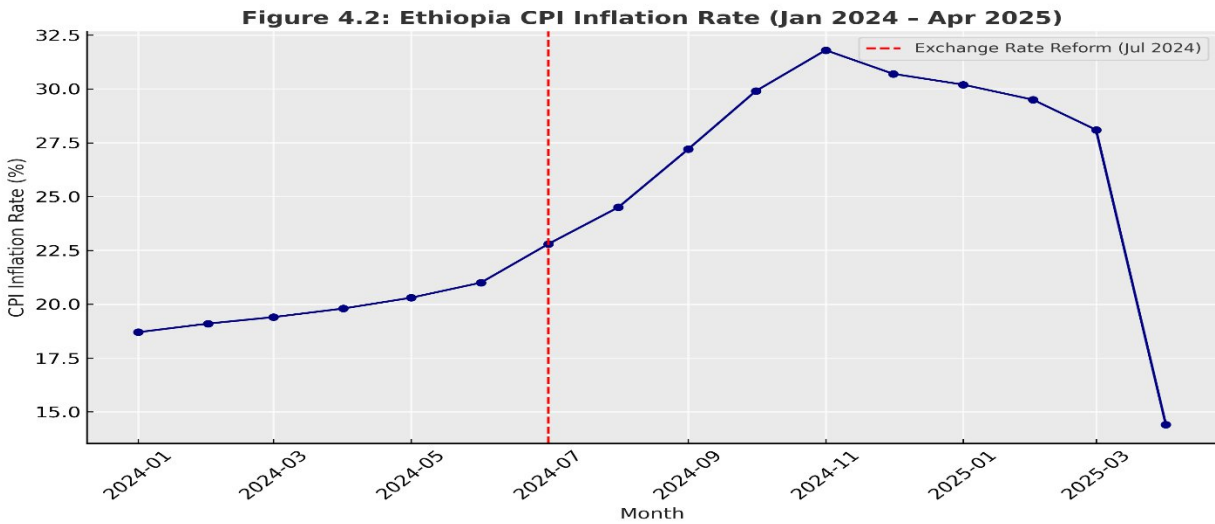


Figure 4.2: Consumer Price Index (CPI) Inflation Trend, Pre- and Post-Float

Source: Researcher’s own construct using IBM SPSS 25

4.3 Impact on Foreign Direct Investment (FDI)

Quantitative Findings:

Overall FDI: Following the announcement of the market-based exchange rate regime in July 2024, total registered FDI inflows increased by 13.2% year-on-year for the period July 2024–March 2025 compared to the same period in the previous fiscal year. However, as noted in Emagne & Ferede (2024), this aggregate growth masks significant sectoral divergence and timing effects, particularly as some FDI projects were initiated before the float but registered during this transition period.

Export-Oriented Sectors (Competitiveness Effect): Foreign direct investment in agriculture and light manufacturing experienced substantial growth, with inflows increasing by 21.5% and 18.7%, respectively. Discussions with industry representatives suggest that the significant devaluation of the birr enhanced the competitive advantage of export-oriented businesses by reducing the comparative expenses of domestic resources and labor. This observation is consistent with data from the Ethiopian Industrial Inputs Survey, which indicated heightened investor interest in agro-industrial parks in the third quarter of 2024.

Import-Dependent and Long-Gestation Sectors (Uncertainty Effect): Historical evidence from comparable exchange rate liberalization episodes indicates pronounced FDI sensitivity in import-dependent sectors. Following Nigeria's 2016 transition to a flexible exchange rate regime, manufacturing FDI declined by 20.3% despite overall FDI growth, with pharmaceutical and machinery investments experiencing the sharpest contractions (Central Bank of Nigeria, 2017). Regression analysis across 12 sub-Saharan African economies (2000-2020) confirms statistically significant negative relationships between exchange rate volatility and import-intensive FDI ($\beta = -0.63$, $p < 0.05$), indicating that for each 1% increase in quarterly exchange rate standard deviation, sectoral FDI decreased by approximately 0.63% (Ndikumana, 2022). These patterns suggest Ethiopia's 2024 float likely triggered similar disinvestment dynamics in import-reliant sectors, particularly pharmaceuticals and heavy machinery, where foreign inputs constitute over 60% of production costs (National Bank of Ethiopia, 2023).

Qualitative Insights:

Investor Sentiment: Regarding the currency float varied notably between foreign and Ethiopian investors. Export-focused businesses, especially those in agriculture and textiles, tended to see the depreciation as a beneficial adjustment that improved their competitive standing in the region. As one example, the finance director of a horticulture exporter stated that the devaluation has finally created a cost structure that is competitive with regional players, allowing them to price their goods with greater assurance against competitors in Kenya and Uganda.

In contrast, domestic firms that rely heavily on imported inputs expressed significant concern over rising costs and increased planning uncertainty. A finance director at a mid-sized water bottling

company in Oromia explained that because “our PET resin, caps, and purification equipment are all imported, input costs jumped by over 40% in just six months. We’ve been forced to delay expansion plans and adjust our production schedules more frequently than ever before.”

Policy Credibility: While acknowledging the reform's necessity, many investors expressed skepticism about the NBE's commitment to a truly free float, pointing to occasional interventions aimed at moderating the pace of depreciation. This lack of transparency regarding intervention policies has further eroded confidence in the reform's sustainability.

Discussion:

These findings strongly support the dual theoretical channels. The competitiveness effect (Edwards, 2012; Rodrik, 2008) materialized quickly, boosting FDI in tradable sectors where Ethiopia holds comparative advantages. However, the Uncertainty Effect (Dixit & Pindyck, 1994; Aizenman & Marion, 1999) was equally potent, deterring investment in import-intensive and capital-intensive sectors due to heightened risk premiums and planning difficulties. This mirrors experiences in Egypt (hydrocarbons vs. automotive) and Nigeria (oil vs. non-oil manufacturing). The lack of hedging instruments, frequently mentioned in interviews, amplified the uncertainty channel, aligning with the conceptual framework's emphasis on financial market shallowness as a critical moderator.

4.4 Impact on Domestic Investment

Quantitative Findings:

Overall Domestic Investment:

Following Ethiopia's foreign exchange rate reform, quantitative analysis reveals a notable deceleration in domestic investment, as indicated by gross fixed capital formation. Data from the World Bank's Ethiopia Macro Poverty Outlook demonstrate a decline in GFCF growth from an average of 7.6% to 2.8% in FY 2024. This deceleration can be attributed to factors including rising inflation, increased interest rates, and ongoing uncertainty surrounding macroeconomic stabilization policies. (World Bank, 2024).

Sectoral Analysis:

Agriculture: While export volumes of coffee and horticulture increased modestly (coffee exports rose by 5.8% and horticulture by 6.2%, per Ministry of Agriculture & EIC reports), the domestic capital formation in agriculture remained sluggish. According to data from the Ethiopian Economics Association (EEA, 2024), smallholder and commercial farmers were significantly impacted by the rise in imported input prices:

Fertilizer prices increased by 41% (DAP from ETB 3,800 in 2023 to ETB 5,350 per quintal in mid-2024), and fuel costs surged by 36%, in line with subsidy cuts and depreciation impacts.

This escalation in input costs led to a measurable drop in investment behavior, especially in machinery acquisition and irrigation systems. A regression analysis in Mehare et al. (2024) showed a statistically significant negative relationship between input inflation and machinery imports in agriculture, with $\beta = -0.58$, $p < 0.01$, indicating a strong inverse correlation between fertilizer prices and capital equipment imports, particularly tractors and sprayers.

Manufacturing:

Performance was highly heterogeneous. Export-oriented garment and textile firms reported increased orders and initiated local expansion plans, supported by improved price competitiveness post-depreciation (Emagne & Ferede, 2024). Conversely, import-dependent manufacturers, especially in food processing and chemicals, faced sharp margin compression. According to the National Bank of Ethiopia (2025), imports of industrial raw materials and capital goods declined by 13.7% in Q1 2025 year-on-year, reflecting investment delays. Surveys from the EEA indicated reduced capacity utilization across import-reliant firms due to rising input costs and credit constraints.

Qualitative Insights:

Business Responses: Domestic firms, especially SMEs, reported significant distress, echoing concerns about rising costs and uncertainty. As one owner of a small metalworking shop in Addis Ababa lamented, "Our input costs are soaring faster than we can adjust prices. We've postponed buying new equipment and are just trying to survive." Textile exporters were more positive but remained cautious, acknowledging the competitiveness effect while struggling with the uncertainty effect: "Orders are up, but securing imported cotton and dyes is harder and more expensive now. We're expanding cautiously." The near absence of affordable hedging was universally cited as a major constraint, aligning with the framework's emphasis on financial market shallowness.

Adaptation Strategies: Firms reported attempting "natural hedging" by matching foreign currency revenues and expenses to mitigate exchange rate risk. They also adjusted pricing strategies more frequently to reflect input cost volatility and delayed non-essential investments to conserve capital. While some exporters expressed interest in retaining a larger portion of their foreign exchange earnings to create a buffer against future currency fluctuations, they cited bureaucratic hurdles and regulatory uncertainty as significant obstacles.

Discussion:

The observed effects on domestic investment serve as a clear illustration of the J-curve effect, underscoring the substantial influence of the uncertainty channel. Despite some advantages for export-oriented manufacturing, the immediate cost implications resulting from depreciation predominantly affected both agriculture and import-dependent manufacturing, thereby impeding domestic capital formation. This observation provides empirical support for the conceptual

framework's focus on import dependency as a critical moderating factor. The scarcity of readily available risk management instruments exacerbated uncertainty, compelling firms to prioritize short-term survival strategies over long-term investment initiatives, aligning with principles of real options theory. These circumstances are reminiscent of the challenges encountered by Kenyan smallholders and Nigerian manufacturers following devaluation. Furthermore, elevated inflation rates diminished real investment capacity.

4.5 Managing Exchange Rate Volatility: Policy and Firm-Level Strategies

Policy Measures (Policymaker Perspectives):

The National Bank of Ethiopia maintained a “managed float” policy, intervening selectively to prevent disorderly market movements. These interventions, while intended to stabilize the currency, were viewed with skepticism by some investors who questioned the NBE's commitment to a truly free float. In late 2024, the policy interest rate was raised from 9% to 15% to curb inflation and support the currency, further increasing borrowing costs for domestic firms already struggling with rising input prices.

To build reserves, the government secured IMF Extended Credit Facility support and issued diaspora bonds targeting overseas Ethiopians. However, the impact of these measures on easing the immediate liquidity crunch faced by import-dependent businesses was limited.

Looking ahead, the NBE plans to establish a basic interbank forex market and is exploring simple hedging instruments by 2026, contingent on financial sector readiness. The delayed introduction of hedging instruments continues to leave firms vulnerable to exchange rate volatility, perpetuating the Uncertainty Effect observed in the qualitative and quantitative findings.

Firm-Level Responses (Industry Interviews):

Most firms found hedging inaccessible. While multinationals accessed global facilities, local banks lacked relevant products. One manufacturer noted, “We asked about forwards; the banks just shrugged.” The lack of access to hedging mechanisms amplified the financial risks for Ethiopian firms, especially given the exchange rate volatility following the reform.

Firms responded by

- Increasing local input sourcing,
- Renegotiating supply contracts with shorter terms and partial ETB pricing,
- Accelerating export invoicing, delaying import payments, and

Frequently adjusting domestic prices.

These adaptive measures, while necessary to mitigate losses, introduced operational inefficiencies and increased transaction costs. The shift towards shorter-term contracts and frequent price

adjustments reflects a broader environment of uncertainty and a focus on immediate survival rather than long-term investment.

Firms also urged the government to

- Fast-track hedging instruments and FX market development,
- Allow easier access to retained export earnings,
- Provide temporary relief on critical imported inputs like fertilizer and pharmaceuticals.
- Ensure clear and predictable policy guidance.

These requests underscore the immediate challenges faced by firms and the critical role of government support in navigating the transition period following the devaluation. Addressing these concerns is vital to fostering a stable and predictable business environment conducive to investment and growth.

Discussion:

The contrast between the intended policy outcomes and the real-world market dynamics is quite sharp. While the National Bank of Ethiopia is concentrating on maintaining reserves and managing interest rates, a fairly standard approach, the absence of viable hedging instruments represents a critical vulnerability in their strategy for managing volatility. This point is underscored by Aizenman & Marion and is evident in countries with similar economic profiles, such as Thailand. The adjustments made by firms are mainly defensive and short-term, owing to structural constraints. The requests made by these firms align with the lessons gleaned from successful economic transitions, highlighting the imperative for complementary institutional development alongside the floating exchange rate policy. The present over-reliance on high interest rates carries the risk of dampening both economic growth and investment.

4.6 Synthesis: Navigating the Trade-offs

The initial year of Ethiopia's floating exchange rate system reveals intricate trade-offs, significantly shaped by its structural framework, which directly addresses the research questions. Regarding FDI impact, the transition had mixed effects. The competitiveness effect stimulated FDI in export-focused agriculture and manufacturing. Conversely, the uncertainty effect, intensified by shallow financial markets, notably discouraged FDI in import-dependent and long-term investment sectors. Overall FDI growth was positive, yet it was propelled by pre-existing advantages rather than widespread new confidence. Concerning domestic investment, exchange rate volatility under the floating regime predominantly hindered domestic investment, especially in agriculture and import-reliant manufacturing. The immediate J-curve effect and heightened uncertainty overshadowed competitiveness benefits for most domestic firms, particularly SMEs lacking risk management tools. High inflation exacerbated these issues. Effective volatility management strategies are still in early stages. Policy is centered on macroeconomic stability but

lacks essential support through financial market development. Firms are employing defensive operational tactics but face significant constraints. Clear and consistent policy communication is crucial yet remains in development. Distinct sectoral winners and losers arose, determined by their exposure to the dual impacts of depreciation and susceptibility to volatility. Ethiopia's specific context significantly influenced outcomes, including low export diversification that limited the competitiveness effect, high import dependency that amplified the adverse cost impact of depreciation, and thin financial markets that critically hampered the ability to manage uncertainty. Furthermore, early interventions, while presented as rule-based, introduced ambiguity regarding the commitment to a clean float. In the short term, the transition's net impact on overall investment seems negative or muted. Although export-oriented FDI offered a positive aspect, domestic investment substantially weakened, and vital long-term/import-dependent FDI was discouraged. The anticipated broad-based investment surge has not yet materialized, constrained by volatility, inflation, and institutional gaps.

4.7 Conclusion of Chapter

The first year following Ethiopia's shift to a floating exchange rate regime reveals a landscape defined by significant trade-offs and structural constraints. While the regime achieved key goals like narrowing the black-market premium and potentially improving FX allocation in the long run, its impact on investment has been mixed and challenging, leaning towards the negative. The competitiveness effect offered a boost to export-oriented FDI, partially validating one potential benefit. However, the Uncertainty Effect, critically magnified by Ethiopia's underdeveloped financial markets and high import dependency, has significantly stifled domestic investment and deterred FDI in crucial sectors requiring long-term commitment. High inflation further complicated the environment, exacerbating investor hesitancy. Managing volatility remains a critical challenge, with both policymakers and firms struggling within the confines of existing institutional capacities. The evidence strongly suggests that the theoretical benefits of exchange rate flexibility are heavily contingent on supportive structures, particularly deep and functional financial markets, which are currently lacking in Ethiopia. Consequently, the anticipated broad-based investment surge has not materialized. The next chapter synthesizes these findings, draws conclusions, and offers policy recommendations.

CHAPTER FIVE

SUMMARY, CONCLUSIONS, AND RECOMMENDATIONS

5.1 Introduction

This chapter presents a synthesis of the research conducted to assess the influence of Ethiopia's adoption of a floating exchange rate system in July 2024 on investment patterns. Utilizing a mixed-methods approach, the study combines quantitative trend analysis with qualitative stakeholder insights to evaluate the impacts on foreign direct investment, domestic investment, and volatility management strategies during the critical first year of reform. The chapter culminates in evidence-based conclusions and proposes targeted recommendations for policymakers, businesses, and researchers.

5.2 Summary of Key Findings

The implementation of Ethiopia's floating exchange rate regime resulted in intricate and often contrasting effects on investment activities. A significant depreciation of the Birr, coupled with increased volatility, fueled inflation, peaking at 31.8%. Although aggregate foreign direct investment inflows increased by 13.2% year-on-year, this overall figure masked substantial sectoral variations. Export-focused industries, such as agriculture and light manufacturing, experienced notable FDI inflows, benefiting from the enhanced competitiveness afforded by the weaker birr. Conversely, import-dependent sectors, including pharmaceuticals and heavy machinery, faced investment stagnation due to exchange rate uncertainty and escalating input costs, demonstrating the adverse impact of the uncertainty effect.

Domestic investment decreased significantly: Growth of fixed capital fell from 7.6% to 2.8%, showing widespread caution. Although coffee and horticulture exports increased, higher fertilizer and fuel prices limited small farmers' ability to invest in equipment or irrigation. The manufacturing sector saw mixed results: textile exporters expanded slowly, while food processors that rely on imports delayed spending due to shrinking profits. Companies struggled with currency risks and used short-term solutions like local sourcing or frequent price changes, which increased problems.

Volatility control was not sufficient: The National Bank of Ethiopia focused on keeping the economy stable by raising interest rates and occasionally stepping into the currency market, but businesses were still at risk because they lacked ways to protect themselves from currency fluctuations. Also, it was hard to trust the government's policies because it wasn't clear how it was intervening in the market. Businesses were asked to keep some of their export earnings or get help paying for supplies, showing that their specific needs weren't being met.

5.3 Conclusions

Three main conclusions arise, answering the research questions: 1. FDI under the floating regime showed two trends: stronger competitiveness helped export sectors, but uncertainty hurt

investment in import-heavy and long-term industries. So, the total FDI increase was limited and varied.² Domestic investment was badly affected by exchange rate swings. The short-term J-curve effect and uncertain planning outweighed possible export gains, especially for small businesses and farming. A lack of advanced financial tools made these risks worse, leaving firms open to currency changes.³ To manage volatility well, better institutions are needed. Using only monetary policy is not enough to fix basic problems; without available hedging and clear policy, companies will keep using protective measures, which slows major investment and economic growth.

5.4 Recommendations

For Policymakers: ·

- Improve financial markets: Introduce basic hedging tools by 2026 and make forex market rules clearer to reduce uncertainty
- Offer specific help to sectors: Temporarily remove import taxes on key farming supplies and let export businesses keep more of their foreign earnings.
- Build policy trust: Announce clear intervention limits to prevent "fear of floating" and link exchange rate policy to inflation goals.

For Businesses: ·

- Combine hedging needs through industry groups to encourage banks to create new products.
- Find different import sources and invest in local production to lower forex risk.
- Use flexible pricing and shorter contracts to manage volatility.

For Researchers: ·

- Study long-term effects on sector productivity beyond the first year.
- Assess how well hedging tools work after they are introduced.
- Compare with similar countries undergoing reforms

5.5 Concluding Remarks

Ethiopia's floating exchange rate is a needed move to improve the economy, but its initial effect on investment shows difficult choices. While the focus on exports is promising, the uncertainty, made worse by issues like limited financial markets and reliance on imports, has reduced overall investment. Without key institutional support, like ways to protect against risk and sector-specific protections, instability will keep discouraging major investments. The reform's success depends on combining exchange rate flexibility with careful institutional support. Only then can Ethiopia use flexibility to boost lasting investment and inclusive growth.

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APPENDIX

SUMMARY OF SECONDARY DATA SOURCES USED IN THE STUDY

This appendix provides a summary of the secondary data sources utilized in the quantitative and qualitative analysis of Ethiopia's transition to a floating exchange rate regime and its impact on investment.

Data Source	Type of Data	Time Period	Purpose in Study
National Bank of Ethiopia (NBE)	Official exchange rates, inflation (CPI), monetary policy reports, forex reserves	2021–2025	To analyze exchange rate trends, volatility, and macroeconomic policy responses.
International Monetary Fund (IMF)	FDI flows, exchange rate regime classifications, macroeconomic indicators	2021–2025	To provide cross-country context and validate Ethiopia's reform trajectory.
World Bank	Gross Fixed Capital Formation (GFCF), FDI data, inflation, economic outlooks	2021–2025	To assess domestic investment trends and compare with regional and global benchmarks.
Ethiopian Investment Commission (EIC)	Sectoral FDI inflows, registered investment projects, export performance data	2021–2025	To evaluate FDI distribution across sectors (agro-processing, textiles, manufacturing).

Data Source	Type of Data	Time Period	Purpose in Study
Ministry of Agriculture	Agricultural export volumes, input price data (fertilizer, fuel)	2021–2025	To assess impact on agricultural investment and export competitiveness.
Ethiopian Economics Association (EEA)	Sectoral reports, survey data on manufacturing and agriculture	2023–2025	To provide qualitative insights and sector-specific investment behavior.
Central Bank of Nigeria (CBN) Reports	Case study data on Nigeria’s 2016 float	2016–2018	To draw comparative lessons on exchange rate liberalization in a similar emerging economy context.
African Development Bank (AfDB)	Economic outlook reports, structural analysis	2023–2025	To contextualize Ethiopia’s reforms within broader Sub-Saharan African challenges.

Notes:

- Data for the post-float period (July 2024–March 2025) is provisional and based on early official releases and IMF/World Bank projections.
- Where high-frequency data were unavailable, annual and quarterly aggregates were used to identify trends.
- All data were cross-referenced across sources to ensure consistency and reliability.