INSIGHTS ON ETHIOPIA'S EXCHANGE RATE REFORM

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Table of Contents

1. Introduction

Ethiopia recently underwent a significant exchange rate reform as part of an International Monetary Fund (IMF)-backed macroeconomic stabilization program. The IMF has consistently pushed for adopting a floating exchange rate in Ethiopia, arguing that the local currency (ETB) is overvalued compared to the USD and other major foreign currencies. The World Bank and IMF often advocate for a market-based exchange rate system that unifies the official rate with the much higher black-market rate (Brian[1], 1989). The Ethiopian government has been in talks with the IMF for a rescue loan or financial support to address the key macroeconomic imbalances facing the economy.

The war-affected economy has been grappling with a severe shortage of foreign exchange reserves, a growing external debt problem (about $28 billion), and high debt servicing costs (approximately $2 billion annually). As of May 2024, foreign exchange reserves were sufficient for about 1 month of imports, and there were growing pressures on the fiscal and current account balances (UNDP, 2024).

A thriving black market, a significant disparity with the official exchange rate, and the increasing reliance of businesses on the black market for their imports have been challenging the government and the country at large. Moreover, though Ethiopia has secured a temporary debt service suspension from the Paris Club, its debt restructuring was conditional on reaching an IMF program. The Ethiopian government has implemented exchange rate reforms as a key component of its Home-Grown Economic Reform Plan (HGER 2.0), anticipating that this policy shift will yield substantial economic benefits for the nation. The government highlights that the reform is domestically driven and not an IMF-induced program. However, critics argue that the country's severe macroeconomic challenges, which necessitate substantial foreign financing, have left the government with little alternative but to adopt the IMF's proposed exchange rate and broader macroeconomic reforms (ECOEMERGING[2], 2024).

The package of macroeconomic reforms—based on the country's Home-Grown Economic Reform Plan (HGER 2.0)—aims to restore macroeconomic stability, boost private sector activity, and ensure sustainable, broad-based, and inclusive growth. According to the National Bank of Ethiopia (NBE) (2024), Ethiopia's foreign exchange reform is just one part of a wider package of macroeconomic reforms being implemented and accelerated over the coming months. On July 29, 2024, the government announced the introduction of a competitive, market-based exchange rate

[1] Pinto, Brian R.., *Black market premia, exchange rate unification, and inflation in sub-Saharan Africa (English)*. Washington, D.C.: World Bank Group. http://documents.worldbank.org/curated/en/267081468749361720/Black-market-premia-exchange-rate-unification-and-inflation-in-sub-Saharan-Africa

[2] https://economic-research.bnpparibas.com/pdf/en-US/Emerging-February-13-2024-2/13/2024,49352

system, departing from the ‘managed floating’ exchange rate system (NBE, 2024). The primary goal of the exchange rate reform is to address long-standing foreign currency shortages, boost investor confidence, and ultimately stabilize the economy.

This brief offers a preliminary assessment of the exchange rate reform and acknowledges the limitations inherent in its scope. While a comprehensive quantitative analysis of the reform's implications for key macroeconomic variables and welfare indicators would provide a more robust foundation for policymaking, constraints related to the timeframe and urgency of the issue necessitated this brief to draw initial insights from theoretical considerations, prevailing economic conditions in the country, and a review of comparative international experiences. The potential for a more in-depth examination of the reform’s economic benefits and costs may be considered in future work as warranted by the reform's implementation trajectory, and emerging evidence and policy priorities of the country.

The remainder of this brief outlines the theoretical underpinnings of the exchange rate reform, details its key components, assesses potential benefits and costs, draws on international experiences, and concludes with recommended actions.

1.1 Theoretical Considerations of the Reform

One of the key components of the macroeconomic reform package is implementing a competitive, market-based system to determine the exchange rate. The implications of exchange rate reforms on trade are a contentious topic in theoretical debates. Theoretically, if certain conditions are satisfied, a market-based exchange rate regime can provide several benefits, such as promoting exports, reducing import demand, and narrowing trade balance deficits. The major theoretically expected benefits for Ethiopia (medium and long run) are briefly summarized as follows.

Promoting Exports

Depreciation of the local currency can promote exports by enhancing competitiveness and stimulating the production of diverse export commodities.

- **Enhanced competitiveness:** A depreciated currency makes Ethiopian exports cheaper in foreign markets in terms of foreign currency, increasing their competitiveness relative to products from other countries. By making goods and services more affordable for foreign buyers, depreciation can lead to higher export volumes and revenues. It is noted that currency depreciation usually works through price competitiveness (Zia and Mahmood, 2013; Lee and Naknoi, 2024).
- **Stimulating export-oriented production:** By making exports more competitive, depreciation can incentivize domestic producers to focus on and boost export-oriented production, increasing diversification and adding value to the economy (Ari, 2023).

Reducing Import Demand

Depreciation is expected to reduce the demand for imports by increasing the costs of imports in terms of local currency and enabling the substitution of previously imported goods.

- **Increased import costs:** A depreciated currency makes imports more expensive, discouraging domestic consumption of foreign goods. This can help to reduce the overall import bill and improve the trade balance.
- **Promoting domestic production:** As imported goods become more costly, consumers and businesses may opt for domestically produced alternatives and foster import substitution-oriented production, stimulating domestic production and job creation.

A depreciated currency can contribute to narrowing the trade balance deficit by boosting export earnings. As a result of depreciation, a decline in import spending is expected due to higher prices, which also helps to reduce the trade balance deficit.

In general, there is a theoretical foundation that the currency depreciation of one's country against a foreign country makes its exports cheaper and imports more expensive assuming that demand is price elastic both for export and import, ceteris paribus (Feenstra et al. 2012). While currency depreciation is theoretically viewed to improve the trade balance, the effectiveness of currency depreciation centers on the twin concepts of the Marshall–Lerner (ML) condition and the J-Curve phenomenon. According to the condition, the success of a devaluation depends on whether the sum of import and export demand elasticities exceeds unity. Proponents of this approach argue the M-L condition provides both the necessary and sufficient conditions for an improvement of the trade balance. However, there have been circumstances under which this condition was satisfied yet the trade balance continued to deteriorate (Bahmani-Oskooee, 1985).

It is crucial to note that besides the price elasticity of demand for exports and imports and the responsiveness of domestic producers to export opportunities, the effectiveness of depreciation in improving the trade balance depends on several factors, including the availability of adequate foreign exchange to finance imports. While a depreciation can provide a short-term boost to exports, sustained improvements in the trade balance often require long-term structural reforms to enhance productivity, diversify the export base, and reduce reliance on imports.

Moreover, in theory, the new market-based regime is expected to enhance the efficiency of resource allocation and attract foreign investment by allowing the exchange rate to reflect economic fundamentals more accurately.

What is more, for a floating exchange rate, central banks are not required to keep large foreign currency reserves to defend the exchange rate. Hence, the reserves can be utilized to promote economic growth by importing capital goods. Floating exchange rates can also act as a buffer to insulate a country's economy from shocks, remove the need for large reserves, and grant countries monetary policy independence. However, it also introduces greater exchange rate volatility, which can pose challenges for businesses and individuals.

1.2 Key Elements of the Exchange Rate Reform

Since 1992, the Ethiopian Government has maintained what it calls a 'managed floating' exchange rate regime, occasionally intervening in the foreign exchange market by buying and selling currencies (UN[3], 2020). However, the IMF categorizes this exchange rate regime as a crawling-peg arrangement, i.e. not 'managed float'. This shift from a 'managed floating' exchange rate system has vital economic implications. For instance, the Ethiopian Birr (ETB) immediately depreciated by about 30% (the first day) following the reform. The ETB continued its decline in value over the subsequent days, reaching a rate of 101.43 Birr per US Dollar as of August 5, 2024. This represents a depreciation of approximately 75%.

The newly introduced market-based exchange rate regime included several changes, a significant departure from the previously managed float regime. The key changes include

- **Market-determined exchange rate:** Ethiopia has transitioned from a managed floating exchange rate system to a fully flexible one, allowing the market to determine the value of the Birr against foreign currencies. The exchange rate is set to be primarily determined by supply and demand forces in the foreign exchange market. The NBE will no longer directly intervene to set the exchange rate. The Ethiopian Birr is now allowed to fluctuate more freely in response to changes in market conditions, such as trade flows, capital movements, and investor sentiment.
- **The end of FX surrender requirements to the NBE:** The policy enables exporters and commercial banks to retain foreign exchange, substantially increasing FX supplies to the private sector.
- **Removal of import restrictions:** The import restrictions imposed on 38 product categories have been lifted, and the foreign exchange market has been liberalized for the imports of goods and services (except fuel cars) while capital account outflows remain restricted as before.
- **The improvement of retention rules:** Exporters can now retain 50% of their foreign exchange proceeds, up from 40%.

[3] UN, 2020. Monthly Updates on the Ethiopian Economy. October 2020 issue.

- **Removal of rules governing FX rationing:** The policy involved the complete removal of rules governing banks' allocation/rationing of foreign exchange. It was based on a waiting list system for different categories of imports.
- **The introduction of non-bank foreign exchange bureaus:** Formal non-bank foreign exchange bureaus are allowed to operate and are free to buy and sell foreign currency cash notes at market rates after getting licenses.
- **The removal of restrictions on franco valuta imports,** which will be implemented shortly through an upcoming regulation.
- **The allowance for residents to open foreign currency accounts:** The reform allows residents to open foreign currency accounts based on remittance inflows, transfers from abroad, FX-based salary or rental income, and for other specified cases, as well as the ability to use such foreign currency accounts for foreign service payments.
- **Relaxation of foreign exchange controls:** Certain restrictions on foreign exchange transactions have been eased to promote greater convertibility and facilitate trade and investment. For instance, the reform grants firms within Special Economic Zones the privilege to retain 100 percent of their foreign exchange earnings.

Before the current reform, the NBE set the daily exchange rate according to a schedule targeting a particular devaluation at the end of the period. The NBE would often buy or sell foreign currency to stabilize the exchange rate or achieve specific policy objectives. This intervention limited the flexibility of the exchange rate to respond to market forces. However, the current reform limits NBE's intervention, and the rate is envisaged to be determined by the interaction of market forces.

2. Ethiopia's Current External Trade and Policy Landscape

2.1 External Trade

Ethiopia has a history of devaluing its currency, the Birr, in response to economic challenges. This policy tool has been employed to address persistent balance of payments deficits, foreign exchange shortages, and inflationary pressures of the economy. One of the most significant devaluations was made in 1992 immediately after the Ethiopian People's Revolutionary Democratic Front (EPRDF) regime took power. The Birr was sharply devalued from 2.07 to 5 per US dollar, marking a substantial (142%) devaluation (Elias *et al.*, 2023)[4]. This drastic measure was associated with the conditionalities imposed by the international financial institutions to adjust the overvalued exchange rate and stimulate exports by making Ethiopian goods more competitive

[4] Elias, A., Dachito, A., & Abdulbari, S. (2023). The effects of currency devaluation on Ethiopia's major export commodities: The case of coffee and khat: Evidence from the vector error correction model and the Johansen co-integration test. Cogent Economics & Finance, 11(1).

in international markets. Subsequent devaluations followed in 2010 and 2017. In September 2010, the government made a more moderate devaluation (16.7%), increasing the nominal exchange rate from Birr 13.6 to Birr 16.3 per US dollar. This adjustment sought to address renewed imbalances in the foreign exchange market (Elias *et al.*, 2023). Furthermore, in November 2017[5], the NBE announced a 15% devaluation, bringing the exchange rate to Birr 27 per US dollar. This decision was driven by the need to alleviate foreign exchange pressures and encourage export-oriented growth.

The desired outcomes have been elusive despite the government's intention to stimulate exports through currency devaluation. Both the export and import sectors exhibited muted responses to currency devaluations. The reforms aimed to boost exports by making Ethiopian products more attractive in the global markets and reducing the country's import dependency, but these reforms fell short of expectations. While imports have continued to rise, significant export growth has not materialized following the devaluations (UNCTAD, 2024). Several factors may contribute to this phenomenon. A primary challenge lies in the type and variety of Ethiopia's export basket, which is heavily dominated by agricultural commodities. These products have a lower price elasticity of demand, meaning that price changes have a minimal impact on the quantity demanded.

The other key factor is the overvaluation of Ethiopian Birr in real terms making the country less competitive in the international market. While the Birr has nominally devalued since 2010, its value has strengthened in real terms. A study by Haile (2019)[6] revealed a substantial 23 percent overvaluation of Birr in terms of real effective exchange rate by June 2015, culminating in a 72 percent increase since the 2010 devaluation. This significant strengthening of the Birr has hindered export growth, undermined the country's competitiveness, and posed risks to external stability. In essence, Ethiopian goods have become relatively more expensive on the global market. The overvalued Birr has also contributed to a surge in illicit trade. Key exportable goods like gold and livestock are increasingly diverted to informal channels as exporters find it more profitable to avoid formal export procedures.

Moreover, Ethiopia's position within this limited market space has been eroding due to intensifying international competition. For instance, the country's global market share in agricultural products, which encompasses a substantial portion of its exports, dwindled from 0.13% in 2014 to a mere 0.11% in 2021. While the services sector has demonstrated some growth in its global market share, it remains negligible, falling short of even 0.10% in 2021 (Harvard University, 2021)[7]. These

[5] National Bank of Ethiopia (NBE). (2017). National Bank of Ethiopia 2017/2018. Annual report

[6] Haile F., 2019. The Exchange Rate: Why It Matters for Structural Transformation and Growth in Ethiopia, World Bank Working paper 8868.

[7] Harvard University, 2021. Atlas of the economic complexity assessed online from The Atlas of Economic Complexity (harvard.edu) on August 3, 2024.

figures underscore Ethiopia's significant challenges in expanding its export base and integrating deeper into the global economy even after successive devaluations. Consequently, even with a devalued Birr, the export earnings increment has been relatively modest since primary commodities notably dominate the export basket. For instance, in 2023, the major export commodities of Ethiopia were coffee (46%), flowers (13%), pulses (9%), oilseeds (7%), khat (6%), and gold (5%). These commodities collectively contribute more than 86% of Ethiopia's export basket. Despite their domestic significance, these products collectively hold an insignificant share in the global market (NBE, 2023).

Moreover, supply-side constraints, including limited agricultural productivity, seasonality, inadequate infrastructure, and lack of value addition hindered the export sector's ability to capitalize following the devalued currency. The inelasticity of supply, particularly for commodities that require significant production time, limits the ability to increase exports swiftly after the devaluation.

Furthermore, the export-oriented sectors in Ethiopia often exhibit a high degree of import dependence. For instance, the agricultural sector relies on imported fertilizers, fuel, machinery, and other inputs to boost production. Similarly, the industrial sector necessitates imported raw materials and semi-processed goods to produce exportable products. This intricate linkage between imports and exports creates a complex dynamism, where a simple devaluation of the currency might not necessarily lead to a commensurate increment in exports due to the concurrent rise in input costs.

Ethiopia's import profile is concentrated on raw and semi-finished goods, fuel, fertilizers, and capital goods. These commodities collectively constituted over 75% of the nation's total imports in the last quarter of 2023, as per the National Bank of Ethiopia[8]. This heavy reliance on external inputs underscores a structural vulnerability in the economy. While these imports are indispensable for various sectors, from agriculture and manufacturing to infrastructure development, reducing this dependence is a critical long-term objective; however, in the short run, these imports remain unavoidable due to several factors. The domestic industrial base, particularly in manufacturing, is still relatively nascent and incapable of producing substitutes for many of these goods. Additionally, Ethiopia's agricultural sector also requires significant inputs, including fertilizers and machinery, which are primarily sourced through imports.

[8] National Bank of Ethiopia, 2023. Quarterly Report on Ethiopian Economy

This import-intensive structure presents both challenges and opportunities. On the one hand, it exposes the economy to external price fluctuations and supply chain disruptions. On the other hand, it highlights potential areas for import substitution and domestic value addition, which could enhance economic resilience and create employment opportunities.

Ethiopia's trade balance has deteriorated significantly in recent years, characterized by a stark disparity between imports and exports. In 2023, the country incurred a substantial trade deficit of approximately $14 billion, according to UNCTAD data. Exports for the year totaled around $3.6 billion, while imports surged to $17.9 billion. This imbalance is not a recent phenomenon but rather a deepening trend. The import-to-export ratio, a metric that measures the value of imports relative to exports, has been steadily increasing over time. In 2000, the country imported $3 worth of goods for every $1 exported, but the ratio deteriorated to $6 in 2018 and stood at $5 in 2023. These figures indicate that Ethiopia is spending five dollars on imports for every dollar earned from exports, placing significant strain on its balance of payments.

Such a persistent trade deficit has severe implications for the economy. It necessitates a substantial inflow of foreign exchange to finance the import bill, which can lead to currency depreciation, increased inflation, and external debt accumulation. Moreover, it limits the availability of foreign exchange for productive investments, hindering economic growth and development.

2.2 Policy Environments

Despite claims by the government of policy implementation successes in recent years (PSI, 2024), evidence points out a significant decline in Ethiopia's policy environment since 2020. A marked decline in the efficacy of key policy and institutional frameworks has been observed (EEA, 2024[9]). This erosion has been exacerbated by imprudent macroeconomic policies, particularly in fiscal and debt management.

Compounding these challenges, the country has been affected by widespread domestic conflicts and political instability since 2020. This volatile environment has amplified the negative consequences of poor economic policies, creating a complex and daunting landscape for recovery and growth. These internal challenges compounded by external factors such as the COVID-19 pandemic and the Russia-Ukraine war have resulted in severe economic problems (PSI, 2024)[10]. These problems are reflected by soaring inflation, currency depreciation, and a sharp decline in investors' confidence.

[9] Ethiopian Economics Association (EEA), 2024. Report on the Ethiopian Economy, unpublished book (forthcoming).
[10] Policy Studies Institute (PSI), 2024. Federal Democratic Republic of Ethiopia, Assessment of the Homegrown Economic Reform (HGER) Agenda (2019-2022).

Over the past three decades, the Ethiopian government has introduced a plethora of policies aimed at addressing various socioeconomic challenges. While some positive outcomes have been registered in human capital and social developments, these policies have often exhibited inconsistencies and contradictions. A prime example is the dissonance between policies geared towards equity and social inclusion and those focused on public sector management and institutional development (EEA, 2024). EEA's analysis based on the World Bank's data (2005-2022) shows that while efforts to promote equitable resource distribution, human development, gender equality, and environmental sustainability were initiated, their outcomes fell short of expectations. For instance, general annual inflation surged from 15% in 2018/19 to 34% in 2021/22, far exceeding the government target of single digit. Furthermore, despite aspirations to rank among the top 100 countries in the Ease of Doing Business (EDB), the country has made minimal progress. The Ethiopian Investment Commission's (EIC) modest target of increasing Ethiopia's EDB score from 48 points in 2019/20 to 49 by 2020/21 falls short of the ambition. To catch up with neighboring countries and reach the top 120, Ethiopia must significantly improve its score to around 60 points (PSI, 2024).

These underperformance can be attributed, in part, to the conflicting nature of these policies with broader structural policies. Such lack of harmony among the policies resulted in an imbalanced and misaligned overall development plan, hindering the achievement of policy objectives across different levels and sectors. In such a context, implementing exchange rate reforms, can exacerbate existing imbalances and create new challenges. For instance, a depreciation aimed at boosting exports may be counterproductive if accompanied by high inflation and increased production costs. Similarly, a liberalization of the exchange rate regime might lead to excessive currency volatility if not supported by adequate foreign exchange reserves and effective monetary policy.

A conducive investment climate is intrinsically linked to peace, security, and a robust governance framework. Factors such as property rights, investor protection, access to finance, contract enforcement, and open investment policies are crucial determinants of investment levels. Ethiopia has experienced a sharp decline in investment as conflicts intensified and concurrently, the protection and accessibility of investments have deteriorated (EEA, 2024). This, in turn, impedes the country's ability to leverage the current exchange rate reforms as a catalyst for attracting foreign direct investment. By undermining investor confidence and creating an uncertain business environment, the prevailing conditions limit Ethiopia's capacity to capitalize on the potential benefits of a depreciated currency.

3. Expected Benefits and Costs of the Exchange Rate Reform

Every government policy has both positive and negative effects on the economy. The extent of these effects depends on the country's internal socioeconomic situation, its ability to manage policies, and the international socioeconomic environment. In the following sections, we will outline some of the main potential benefits and drawbacks of the exchange rate reform.

3.1 Benefits

Securing grants and credits

The reform enables the government to secure grants and loans of about 2.5 billion USD immediately from international financial institutions such as the IMF and the World Bank. Additionally, the country's debt was restructured, which allowed it to enhance its forex reserve and get relief to stabilize the market. These financial inflows can bolster the country's forex exchange reserves and improve its debt payment capacity. With strengthened reserves and enhanced access to foreign currency, the government can effectively implement ongoing projects and programs.

Formalize forex marketing

The previous fixed exchange rate system exacerbated imbalances between foreign currency supply and demand, creating a significant gap that fueled the proliferation of a parallel market. The artificially fixed exchange rate failed to accurately reflect economic realities, leading to overvaluation of the domestic currency. This, in turn, discouraged foreign exchange inflows, while simultaneously stimulating demand for foreign currency, particularly for imports. The resulting scarcity and premium placed on foreign exchange created a fertile environment for the black market to thrive.

The shift to a market-determined exchange rate is intended to create a more dynamic and efficient forex market, which grants the autonomy to the market to set exchange rates, the government aims to curtail the prevalence of illegal currency trading, which plagued the economy for a long period. This policy is expected to narrow down the parallel market premium and stimulate formal foreign exchange inflows, as a more competitive and transparent market environment encourages economic activity and investment. Moreover, the new regime will reduce the possibility of dollar repatriation, reduce illegal trades, increasing government revenue through increasing external trade tax collection (as importers would be forced to declare the true local currency equivalent as against the previous case in which importers got a substantial portion of the dollars from the black market and declare in the official exchange take equivalent). Consequently, remittances from the diaspora and other foreign currency sources are anticipated to be channeled through formal banking channels, strengthening the central bank's capacity to manage foreign exchange reserves and support overall economic growth.

Stimulate investment

The new foreign exchange regime empowers private entrepreneurs to actively participate in international trade. This expanded role for the private sector is expected to stimulate economic growth and job creation. Moreover, the liberalization of foreign exchange regulations, including the ability for residents to hold foreign currency accounts at domestic banks would significantly simplify international payments for business communities. This increases accessibility to foreign exchange, facilitates cross-border transactions, and promotes Ethiopia's integration into the global economy.

Proper allocation of foreign currencies

Market-based allocation enables scarce resources to be channeled to the most productive sectors which could have a multiplier effect on the overall economy. Thus, the market-based foreign exchange system adopted by the government optimizes resource utilization and enhances economic efficiency. As a result, the allocation of scarce foreign currency will be directed through market forces towards sectors with the highest potential returns, stimulating growth and job creation. This market-based system is expected to streamline import processes, reduce bureaucratic bottlenecks, and facilitate the acquisition of essential inputs for domestic production. At the same time, the government can also use state banks to implement its national strategy and policies.

Accession to the WTO

The principles and practices of WTO suggest that in Ethiopia different policies in the financial sector system are incompatible with the requirements of the General Agreement on Trade in Services (GATS) and the practices in trade negotiations (Semahagn[11], 2011). One such incompatibility is related to the existing policy that prohibits the participation of foreign financial institutions in the domestic financial market. Since the country is going to fulfill the basic requirements such as liberalization of the financial market, the reform could pave the way to join the WTO in the coming few years.

Trade competitiveness

The depreciation of the Birr can provide Ethiopia with a competitive advantage in international markets. As Ethiopian exports become relatively cheaper for foreign buyers due to the currency depreciation, the potential for increased export volumes and revenues arises. This price

[11] Semahagn Gashu, 2011. Ethiopia’s accession to world trade organization and the implications to its financial sector policies.

competitiveness can stimulate demand for Ethiopian products, contributing to export growth and foreign exchange earnings. However, the effectiveness of this strategy is contingent upon various factors, including the elasticity of demand for Ethiopian exports, the availability of sufficient supply to meet increased demand, and the overall global economic conditions.

3.2 Costs

Inflationary Pressure

Depreciation could lead to an increase in the cost of imported goods, a significant part of Ethiopia's consumption basket. The sharp depreciation of the Ethiopian Birr over the past decade has been a significant contributor to inflationary pressures within the economy. Degye *et al.* (2021) indicate that currency devaluation can exacerbate inflation from both the producer and consumer perspectives. Moreover, the magnitude of inflationary impact tends to intensify with larger devaluation rates, particularly those exceeding 20%. Historical data from 1996 to 2005, as analyzed by Masson and Pattillo (2005), further corroborates this trend, demonstrating higher average inflation rates in countries with flexible exchange rate regimes compared to those with fixed or pegged exchange rates. Consequently, Ethiopia's ongoing currency depreciation is likely to fuel persistent inflation, as the rising cost of imported goods filters through the economy, exerting upward pressure on overall price levels. The inflationary pressure can affect the livelihoods of the population, particularly the poor and fixed-income earners, posing a substantial macroeconomic challenge.

Aggravates Trade Deficit

The anticipated short-term benefits of export expansion through currency depreciation may be limited due to the inelastic nature of Ethiopia's export demand. Moreover, if input costs for exports (both imported and domestically produced) rise due to depreciation and domestic inflation, the positive impact on competitiveness could be reversed. Given these factors, it is unlikely that export revenues will experience a significant uplift in the immediate term. Conversely, the country's heavy reliance on essential imports, for which domestic substitutes are scarce, exacerbates the negative impact of currency depreciation. As the cost of these imports rises, the trade deficit is likely to deteriorate in the short run.

Increased Debt Burden

Depreciation is viewed to be less effective when a country’s debt is denominated in foreign currency. Ethiopia has a high foreign currency-denominated debt, estimated to be more than half of the debt. Thus, following the depreciation of the Ethiopian currency, the debt burden of the country has sharply increased in the local currency. The exchange rate reform would increase the cost of foreign currency-denominated debt in Birr, increasing foreign debt servicing costs, and putting additional pressure on the government's finances.

Difficulty of Forecasting

While currency depreciation can potentially stimulate both domestic and foreign investment by enhancing a country's export competitiveness and profitability, the impact is contingent upon the volatility of exchange rate movements. Highly unpredictable and volatile exchange rate fluctuations pose significant challenges for businesses and investors. Scholars argued that uncertain exchange rate fluctuations would impede international trade and investment, which implies that a stable exchange rate system is better and safer for investors. Investors and businesses thrive on predictability, and sharp and frequent changes in exchange rates introduce significant uncertainty into decision-making processes. Strong volatility could be a challenge for businesses to plan, especially when entering international markets or dealing in foreign currencies. This volatility complicates financial planning, risk assessment, and contract negotiations, discouraging investment and trade. Moreover, in countries such as Ethiopia, where the business community is less experienced with such exchange rate fluctuations, exchange rate volatility can be particularly detrimental. If the exchange rate keeps moving, it could be difficult to know how much the price of merchandise will move both in the short and long run. Thus, the less experienced and educated business community of the country could suffer from this problem.

Oligopolistic Forex Market

According to the IMF (2000), if the foreign exchange market is thin and dominated by a relatively small number of agents, the exchange rate will likely be volatile and determined by a few powerful agents unless the authorities have active support and guidance. This problem could be compounded if there is a long track record of macroeconomic problems such as inflation, unemployment, and BOP deficit. Since those problems are persistent issues in Ethiopia, IMF's concern could emerge in the economy after implementing the floating exchange rate.

3.3 Country Experiences

In 2023 the Central Bank of Nigeria announced a forex market shift towards a market-based approach (Stephen[12], 2023). The huge gap between the official and black-market rates caused severe foreign currency shortages by discouraging supply to the official market. Nigeria's black market handles most of the foreign exchange transactions in the country. The naira depreciated by around 100% against the U.S. dollar from 461 in May 2023 to 900 naira/US dollar at the end of 2023 after the exchange rate regime change. The exchange rate further depreciated by another 40% in January/February 2024. Hence, the headline inflation reached 32% year-on-year in February 2024 (IMF, 2024)[13] due to the poor agricultural production, higher energy, and transportation costs after the depreciation of Naira. Moreover, the gross international reserves

[12] Stephen Onyeiwu, 2023. Economic effect of Nigeria's new foreign exchange policy.
[13] IMF, 2024. Available at https://www.elibrary.imf.org/view/journals/002/2024/102/article-A001-en.xml

declined, the financial account worsened due to persistent capital outflow pressures, and FDI remained subdued. The IMF recommended a package of policies that restores macroeconomic stability through a tightening of policies to rein in inflation and reduce naira pressures, combined with structural reforms to ease trade barriers, strengthen the business environment, and incentivize job creation.

In 1985, Zambia embarked on a comprehensive economic liberalization program, encompassing foreign exchange, external trade, domestic commerce, and industrial restructuring. These reforms garnered significant international attention, with the IMF recognizing Zambia as a pioneering model of structural adjustment in Africa. By May 1, 1987, the immense pressures on the economy necessitated a return to a fixed exchange rate regime. This policy reversal precipitated the withdrawal of IMF support and the imposition of stringent limits on external debt servicing. Zambia's worst economic performance was after the exchange rate system became market-determined (Kombe, 2004)[14]. The transition in the exchange rate regime dislocated the economy with an annual average real GDP growth rate of -0.6% and severe macroeconomic instability. During the same period, parastatal companies collapsed, and productivity plummeted even further, with high rates of company closures and unemployment.

In March 1993, India implemented a market-determined exchange rate system, allowing supply and demand forces within the interbank market to dictate the rupee's value. However, this newfound flexibility proved to be a double-edged sword. The Indian rupee endured episodes of pronounced depreciation against the U.S. dollar in late 1995, 1997, 1998, and 2001. These sharp declines in the currency's value posed significant challenges to the economy. As a result, the Reserve Bank of India was compelled to intervene in the foreign exchange market on multiple occasions to stabilize the rupee and mitigate the adverse impacts of excessive volatility.

Pakistan transitioned to a floating exchange rate system in July 2000, allowing market forces to determine the value of the rupee. However, between November 2000 and 2001, the Pakistani rupee experienced a notable depreciation against major currencies. To mitigate the destabilizing effects of this currency volatility, the State Bank of Pakistan implemented foreign exchange market interventions. These interventions took the form of direct buying and selling of foreign exchange and the provision of foreign currency liquidity to commercial banks for financing specific high-value imports.

Sri Lanka embarked on a path towards exchange rate liberalization on January 23, 2001, by adopting a floating exchange rate regime. However, the immediate aftermath was characterized

[14] Kombe Oswald Mungule, 2004. The determinants of the real exchange rate in Zambia. AERC Research Paper 146 African Economic Research Consortium, Nairobi. Available at https://aercafrica.org/old-website/wp-content/uploads/2018/07/RP_146.pdf

by pronounced volatility in the foreign exchange market, as supply and demand forces exerted significant pressures on the rupee. This heightened instability compelled the authorities to intervene decisively, implementing stringent capital controls to stabilize the exchange rate and prevent further deterioration.

Malawi: It has tried several exchange rate regimes since 1985, most lasting only a short period Nils *et al*. (2013)[15]. The stop-reverse-and-go exchange rate policies resulted in larger real exchange rate volatility, lower growth, less economic diversification, higher inflation between 1990 to 2010, and repeated foreign exchange shortages, rationing, and large parallel market premiums. Finally, the country reverts to a controlled exchange rate regime to lower the inflation rate. The effort succeeded, accompanied by a bumper harvest in 1996: by end-1996 the inflation rate had been brought down to below 10%.

Kenya: The foreign exchange market was liberalized gradually in the early 1990s. A floating exchange rate regime was adopted in October 1993, which increased exports sharply and improved the current account markedly. Hence, the international reserve coverage improved sharply. Holders of foreign exchange abroad responded to the liberalized exchange rate regime, positive exchange rate expectations, and renewed economic stability. Growth also recovered during 1994–96 compared to the level in 1991–93, but the growth recovery was not sustained. Nils *et al*. (2013) identified that monetary policies and expectations were prominent challenges in the exchange rate depreciation and accelerating inflation.

Ghana: Since 1983 it has chosen a gradual approach to exchange rate change with an initial correction of the overvaluation through a series of large, discrete exchange rate adjustments, accompanied by fiscal tightening, before launching a foreign exchange auction market to allow the exchange rate to be market determined by forces and legalizing foreign exchange bureaus, and finally achieving a unified exchange rate system. The economy responded quickly to the reform: GDP per capita grew, exports and imports also picked up quickly, fiscal adjustments were facilitated, and the international reserve coverage increased quickly. In achieving these, the fiscal and monetary policies were the facilitators of the orderly exchange rate and trade liberalization.

In 1986, Tanzania had an economic recovery reform with the centerpiece of a large devaluation of the shilling. Between 1986 and mid-1993, “the country gradually removed import restrictions, adjusted the exchange rate regularly, progressively reduced the foreign exchange surrender requirements, and reformed the export marketing” (Nils et al., 2013). As of the depreciation, the country gradually reduced the parallel market premium to give protected sectors time to adjust to

[15] Nils Maehle, Haimanot Teferra, and Armine Khachatryan, 2013. Exchange Rate Liberalization in Selected Sub-Saharan African Countries Successes, Failures, and Lessons. IMF Working Paper African Department: WP/13/32. https://www.imf.org/external/pubs/ft/wp/2013/wp1332.pdf

market forces. Foreign exchange bureaus and foreign currency deposit accounts in domestic banks were introduced in 1992. Hence, the official and parallel market rate was unified in mid-1993, and current account transactions were fully liberalized. Thus, per capita growth responded strongly to the initial reforms and has been increasingly in positive progress, while inflation and fiscal deficits remained critical problems.

4. Concluding Remarks

Transitioning to a market-based exchange rate regime is a complex process with both advantages and disadvantages. It is important to note that the success of the new exchange rate regime will depend on several factors, including the price elasticity of demand for exports and imports, the responsiveness of domestic producers to export opportunities, the capacity to implement import substitution, development of a deep and liquid foreign exchange market, the effectiveness of monetary policy, and the overall macroeconomic environment. The effectiveness of exchange rate reforms in stimulating exports, a common objective of such policies, is questionable in Ethiopia's case due to the country's export structure, dominated by low-price elasticity agricultural products, which are the main source of Ethiopian exports. Without addressing underlying supply-side constraints and improving export competitiveness, currency depreciation may yield limited results.

Its effectiveness also depends on the broader macroeconomic environment, complementary policy measures, and the behavior of economic agents. Ethiopia's current economic landscape, characterized by macroeconomic instability and political unrest, complicates the potential benefits of currency devaluation. Implementing such a policy in this context could exacerbate existing problems, including inflation, which would disproportionately affect vulnerable segments of the population and potentially drive them into poverty. That is, while currency depreciation can serve as a tool to address macroeconomic imbalances, it is essential to recognize its potential drawbacks. Previous attempts to weaken the Ethiopian Birr through policy or market forces have not been effective in boosting exports and narrowing trade deficits. Increased inflation and erosion of purchasing power are common risks associated with this policy. As such, the market-induced depreciation amidst a stagnant export sector and weak import substitution capacity can lead to inflation and may cause more harm than good in the short run.

While the reform might be vital to address some of the lingering economic problems in the long run, the timing of the reform may adversely affect economic outcomes in the short run. Given the macroeconomic imbalance, the supply-side rigidities, and conflict and instability, it appears to be not the right time for Ethiopia to pursue the reform. Importantly, the reform was introduced at a time when Ethiopia was dealing with conflict. Moreover, the country is in a fragile economy, facing supply-side rigidity persistent inflation, a wide budget deficit, an adverse balance of trade, and significant foreign currency-denominated debts. These challenges may offset the possible benefits of the exchange rate reform.

5. Recommendations

While a floating exchange rate can offer certain advantages, such as automatic balance of payments adjustment, its implementation in a foreign exchange-constrained environment like Ethiopia requires careful consideration and a comprehensive strategy to manage the associated risks. Ethiopia's specific economic conditions will determine the overall impact of this policy change. A combination of the following strategies could be considered to optimize the benefits and minimize the risks associated with the exchange rate reform.

A. Enhancing Productive Capacity and Addressing Supply-Side Rigidities

The rigidity inherent in the supply side and weakening productive capacity shall be addressed through various strategies.

(i) Ensuring peace and stability

Domestic conflicts and political instabilities have substantially stagnated all productive capacities. The capacity to produce more goods and services, including for export, will not significantly change in the short run. In the presence of domestic conflicts and political instabilities, the expected FDI may not be improved. Perhaps, the investment confidence is very low even among domestic investors.

For exports to respond to the exchange rate reform and local and foreign investors to react to the opportunities arising from the reform package, the investment climate, notably peace and stability shall be ensured. Violence and conflict not only hinder investment but also disrupt the supply chain, ultimately fueling inflationary pressure. Therefore, ensuring peace and stability is central to a successful economic reform in Ethiopia.

(ii) Improving the overall business environment and reducing transaction costs

Besides the lingering conflicts, there is a need to address supply constraints by improving the supply chain through the development of infrastructure including transport networks, facilitating adequate access to raw materials and inputs for farmers and manufacturers, enhancing the capacity of local input suppliers, facilitating access to new technologies of production, improving access to markets, enhancing the quantity and quality of other types of infrastructure such as electric supply, ICT and human development.

B. Improving the Country's Trade Performance and Structure

(i) Export diversification

Dependence on a few primary exports could be reduced by diversifying the export base and structure of exportable products. In the long term, reducing dependence on primary exports (or breaking away from dependence on a narrow range of primary exports) that are susceptible to global price volatility and domestic vagaries of nature is critical to boosting export earnings.

(ii) Stimulating import substitution

Notably, dependence on imports can be reduced through designing strategies that reduce reliance on imports. In this regard, in the short to medium term, import substitution strategies shall be promoted to replace previously imported basic goods. This could be achieved through strategies that focus on substituting basic consumer goods such as edible oil, and other strategic imports such as fertilizer by boosting domestic production. Such strategies can reduce reliance on imports and address the persistent foreign exchange problem in the country.

C. Strong Macroeconomic Management and Social Welfare Measures

(i) Sound fiscal and monetary policy measures

Sound fiscal and monetary policies are crucial to stabilize the economy and mitigate inflationary pressures arising possibly from currency depreciation. To contain the inflationary effect of depreciation, the NBE shall implement a strict monetary policy limiting the growth of money including direct financing of deficits, maintaining the credit expansion introduced in 2023, and ensuring effective management of its budget.

(ii) Strengthening the regulatory and capacity of key institutions

Regulating the financial institutions regarding the use and allocation of FX and retailers and wholesalers of goods is vital to avoid unnecessary/unreasonable price increments. Careful regulation, monitoring, and adjustments will be necessary to mitigate potential risks and maximize the benefits. Experiences from various countries vividly showed that a well-regulated, well-supervised, and financially sound banking system is a crucial requirement for a floating exchange rate regime since the banks should be the intermediating actors in the marketing.

(iii) Deepening foreign exchange reserves

Though it might offer a temporary solution, building up adequate foreign exchange reserves can mitigate the rapid depreciation of Birr in the short run and can also provide a buffer against external shocks. Given the limited foreign currency supply, the

NBE may need to inject adequate FX reserves into the financial system, such as through auction to ease the pressure from the demand side.

(iv) Strengthening subsidies and spending on social safety nets

One of the downsides of the exchange rate reform is high inflation arising from rising import prices. Consequently, the welfare of citizens will generally be eroded in the short run. To safeguard the most vulnerable members of society from the adverse effects of depreciation and mitigate the price increment impact, it is crucial to strengthen subsidies for the import of essential goods in the short run. However, this may not be a lasting solution as this erodes the government's revenue and is against the objectives of ensuring fiscal discipline/ensuring a lower budget deficit.

In line with the government's strategy, in the short term, the implementation of effective social safety nets and spending on social services can help protect vulnerable populations from the negative impacts of inflation, which may be fueled by currency depreciation. To avoid dependence, specific strategies can be designed to link the provision of safety nets with production and income-generating activities.