

Policy Brief

Flotation of the Ethiopian Birr and Its Economic Implications

Output from: A Joint International Conference on Currency Flotation

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1. Executive Summary

The International Conference on the Flotation of the Ethiopian Birr, held from January 23–25, 2025, in Addis Ababa, brought together key stakeholders from different actors and countries to discuss the implications of transitioning to a market-based exchange rate. The conference aimed to explore the benefits, challenges, and long-term impacts of a floating Ethiopian Birr, with a focus on its effect on monetary and fiscal policies, trade, and financial sector performance. The research papers presented, and the panel discussions highlighted both the successes and challenges faced in Ethiopia's currency reform and featured international perspectives on similar reforms across Africa and beyond. This policy brief summarizes the key findings and provides policy recommendations to ensure the success of this reform and its integration into broader African economic governance.

2. Background

Historically, the Ethiopian Birr was pegged to the US Dollar, a policy that offered not only limited flexibility but also introduced significant challenges for the country's economy, particularly in terms of competitiveness, inflation control, and macroeconomic stability. In July 2024, the government initiated the flotation of the Ethiopian Birr as part of its Homegrown Economic Reform Agenda (HERA II), signaling a shift towards a more market-determined exchange rate system. The reform aims to address structural issues such as trade imbalances, low foreign exchange reserves, and an overvalued currency, while promoting export competitiveness, attracting Foreign Direct Investment (FDI), and enhancing economic resilience.

However, floating the currency introduces risks such as increased exchange rate volatility, inflationary pressures, and potential disruptions in the financial sector. The conference explored these risks and the necessary steps to mitigate them, while focusing on the broader implications for Ethiopia's macroeconomic framework.

3. Key Findings

Positive Developments Post-Flotation: The flotation of the Ethiopian Birr has led to an increase in foreign exchange reserves and improvements in export receipts and trade balance.

Narrowing of the gap between the official and parallel exchange rates, with the official rate rising from 114.72 ETB/USD to 127.92 ETB/USD, and parallel rates dropping from a peak of 165.7 ETB/USD to 142 ETB/USD.

Inflationary Pressures: Immediate inflationary effects, especially in food and energy prices, were noted, driven by global supply shocks and currency depreciation. A tightening of monetary policy has led to signs of moderation in inflation, though it remains a major concern.

Financial Sector Adaptation: Commercial banks have faced challenges in adapting to the new foreign exchange regime, with liquidity risks and exchange rate volatility affecting profitability. Improved foreign currency management has bolstered bank reserves, but concerns remain about the stability and capacity of smaller financial institutions.

Regional Insights on Currency Flotation: Experiences from other African countries, demonstrated the potential for significant short-term challenges, including sharp currency depreciation and inflation spikes, followed by stabilization over time with the right policy interventions.

Impact on Trade and Competitiveness: Currency flotation has the potential to enhance export competitiveness by making Ethiopian goods more affordable on international markets, though this benefit may take time to fully materialize.

4. Policy Recommendations

i. Strengthening Monetary Policy Tools

- To mitigate inflationary pressures, the National Bank of Ethiopia (NBE) should continue tightening monetary policy, utilizing interest rate adjustments and reserve requirements to manage liquidity.
- The NBE should also develop clearer strategies for foreign exchange market interventions to stabilize the Birr without undermining the goals of the reform.
- **Revise and ensure consistency between existing and new regulations:** The capital adequacy framework, currently based on Basel I, should be updated to incorporate foreign exchange volatility risks. Additionally, the Liquidity Coverage Ratio (LCR) requirements should be revised to include provisions for foreign-currency liquidity management, aligning with international best practices. This will help mitigate liquidity risks and strengthen the banking sector's ability to withstand external shocks.
- **Introduce hedging instruments:** Existing financial laws (Proclamation No. 592/2008) prohibit speculative forex instruments, leaving banks and importers exposed to unhedged currency risks, which heightens systemic vulnerability. Establishing a regulatory framework for controlled hedging mechanisms would help reduce volatility and strengthen financial resilience.

- **Regulatory Framework for Non-Bank Foreign Exchange Bureaus:** The regulatory framework for independent non-bank foreign exchange bureaus is insufficiently detailed, lacking comprehensive oversight mechanisms for compliance with anti-money laundering and combating the financing of terrorism (CFT) regulations.
- **Enhance the Ethiopian Automated Transfer System (EATS):** Under Directive No. EATSO/01/2022 to better facilitate international payments, as its current focus on domestic transactions within the RTGS system limits cross-border efficiency.

ii. Financial Sector Support and Capacity Building

- A robust regulatory framework should be developed to support financial institutions during the transition, including the provision of risk management tools such as currency hedging products.
- There is a need for enhanced technical capacity in the banking sector to handle increased foreign exchange volatility and to streamline the integration of non-bank forex bureaus.

iii. Public Awareness and Stakeholder Engagement

- Continued communication with businesses, consumers, and investors is crucial to build confidence in the new exchange rate regime and to manage expectations regarding inflation and economic stability.
- The government should ensure that policies are aligned with the needs of key sectors, including agriculture and manufacturing, to mitigate adverse impacts.

iv. Regional Integration and Policy Harmonization

- Ethiopia should actively engage in regional economic cooperation, particularly with COMESA and the African Union, to ensure that currency reforms align with broader integration objectives outlined in the Abuja Treaty.
- Strengthening regional policy coordination will help mitigate external vulnerabilities and provide a framework for responding to global economic shocks.

v. Diversification of Exports and Sustainable Growth Strategies:

- To capitalize on the potential benefits of a more competitive exchange rate, Ethiopia must diversify its export base, focusing on sectors beyond traditional commodities like coffee and textiles.
- Long-term structural reforms should aim to reduce dependence on foreign aid and remittances, fostering a more self-reliant and resilient economy.

5. Conclusion

The flotation of the Ethiopian Birr represents a significant policy shift with both challenges and opportunities. While the short-term effects may include inflationary pressures and financial sector disruptions, the long-term benefits such as improved export competitiveness, increased FDI, and macroeconomic stability hold the potential to transform Ethiopia's economy. By strengthening monetary policy frameworks, supporting the financial sector, engaging with regional economic initiatives, and diversifying exports, Ethiopia can navigate the complexities of this transition and achieve sustainable economic growth. The insights from the conference underscore the importance of strategic, coherent, and inclusive policymaking to ensure that the reform delivers on its promises.

Following the floatation of the Ethiopian Birr, it is recommended that the government ensure fiscal prudence by maintaining a tight rein on its on its expenditure to avoid fueling inflation. Keeping government expenditure in check will help manage aggregate demand and hence contain inflationary pressure. This will also help achieve economic stability, allowing the private sector to flourish and fostering an environment conducive to investment, economic growth, and job Creation.

The experience of different countries emphasizes the importance of gradualism, strong regulatory oversight, export-driven growth, and crisis preparedness. The phased approach gives the bank leverage to develop internal capabilities and time to adapt to a changing new system. Furthermore, the robust regulator oversight increased the likelihood of being solvent despite increased exposure to foreign exchange risks. Whereas aligning with export-led economic growth priorities helped the banks to offset risks through increased demand for credit and access to hard currency supply. Finally, investment risk management infrastructure enabled the banks to manage crises or shocks effectively.



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