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þÿEnforcing Ethiopia s Foregn E Regulation in the Parallel Market

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ENFORCING ETHIOPIA'S FOREIGN EXCHANGE REGULATION IN THE PARALLEL MARKET

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ENFORCING ETHIOPIA'S FOREGN EXCHANGE REGULATION IN THE PARALLEL MARKET

Thesis

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By

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Thesis Approval Page

The thesis titled "*Enforcing Ethiopia's foreign exchange regulation in the parallel market"* by Ms. Fedila Shehebo Hussen is approved for the degree of Master of Laws (LLM).

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Statement of Declaration

I, Fedila Shehebo, declare that this thesis titled "***Enforcing Ethiopia's foreign exchange regulation in the parallel market***" submitted in partial fulfillment of the degree of Master of Laws (LLM) is my own work. As to the researchers' best knowledge, this study has not been submitted for any degree in this University or any other University. I have duly acknowledged and referenced all materials used in this work. I know that non-adherence to the principles of academic honesty and integrity, misrepresentation/fabrication of any idea/data/fact/source will constitute sufficient ground for disciplinary action by the University and can also evoke criminal sanction from the State and civil action from the sources which have not been properly cited or acknowledged.

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Signature

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Name of Student

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University Id. Number

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Date

Dedication

I would like to dedicate my work to my beloved mom , Nejat Nuri ,for everything she did to see my success and Dad, Shehebo Hussen, who put the value of education in a little girl mind. May Allah give you long age staying healthy and happy I have no word to thank you.

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First of all, I would like to thank the Almighty Allah, for his permission to finish this work. May praise and glory be for Allah, the Almighty.

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Lastly and most importantly I am thankful to Eyader Teshome for providing materials.

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ACRONYMS

ADDBS	The accelerated duty drawback schemes
AML	Anti money laundering
BOG	Bank of Ghana
BOP	Balance of payments
CFT	Controlling financing terrorism
DBE	Developmental bank of Ethiopia
DDB	Duty draw backs
DER	Dual exchange rate
ERCA	Ethiopian revenue and Customs authority
FATF	Financial Action Task Force
FIC	Financial Intelligence Center
FOREX	Foreign exchange
GDP	Gross domestic product
GTP	Growth and Transformation plan
ICT	Information communication technology
IZ	Industrial zone
LC	Letter of credit
NBE	National bank of Ethiopia
RSP	Remittance Service providers
USD	US Dollar

Abstract

Ethiopian economy is dependent on high importation from foreign countries. The export sector is predominantly agricultural products whose proceed can't finance the importation of the country. This is the natural cause for foreign currency scarcity in the country. The foreign exchange shortage which the government reacts to it through strict foreign exchange control in turn creates the parallel market for foreign exchange as an alternative means of foreign exchange market. The Ethiopian government has enacted different regulation as to who can get the foreign currency, in what conditions and the maximum amount allowed. Moreover, the first come first served procedure with priority lists excluded many demand from accessing foreign currency in the formal channel. Most Importers, traders, medical payments, travelers' costs, education fee and other invisible payments is being financed by the parallel market. However the parallel market is excluded from Ethiopia's foreign exchange regulation. As a result the country's foreign currency is being managed by individuals who are not accorded legal recognition. Excluding the parallel market from Ethiopia's foreign exchange regulation affects the country's economy. There is no transparent capital flow in the country which results in distorted economic and monetary policy. The government cannot allocate foreign currency according to its policy. Formal channel's foreign currency is dried as the supply of foreign currency is diverted to the parallel market. Unregulated parallel market also create suitable environment for illicit activities like money laundering and capital flight.

The paper assesses the treatment of the market in Ethiopia's foreign exchange regime and all the policy measures taken by the government to combat the problem. In doing so, this research is a blend of both doctrinal and empirical (socio-legal) research that has carried out through qualitative methodology. Criminalizing the act with harsh penalty, Export incentives, devaluation, monitoring under invoicing and other measures have been taken as a response to the problem. But all those measures by the government remain ineffective to address the problem. The major finding of the research is that excluding the parallel market from Ethiopia's foreign exchange regulation is detrimental to the economy. The government should absorb the parallel market in to the formal market by enforcing the foreign exchange regulation which authorizes NBE to license dealers. In doing so, the government can avoid the problems arising from unregulated parallel market.

CHAPTER ONE

INTRODUCTION

1.1Background of the study

Parallel markets for foreign currency have emerged in most countries since time immemorial mainly as a result of government controls on access to foreign exchange.[1]When faced with foreign exchange constraints, governments of developing countries often prefer foreign exchange controls by tight macroeconomic policies to protect their international reserves.[2]

These controls precipitate the foreign currency shortage leading to the development of foreign exchange black market. In most instances, a country with an over-valued currency fails to meet the demand for foreign exchange with sufficient supply. As a result, it rations the scarce available foreign currency and imposes controls.[3]

A combination of different factors contributed for both surfacing and later expansion of parallel market. The prevalence of a large parallel foreign exchange market in developing countries is mainly attributed to the existence of restrictive foreign exchange control and the existence of foreign exchange scarcity in the formal market, making operating in the formal sector excessively expensive.[4] Extensive controls on foreign exchange limits the accessibility of foreign exchange in the official market, which throw an increasing number of foreign exchange demanders out of the official market.[5] This led to the emergence of an illegal market for foreign exchange. Moreover, Parallel market may also exist to finance legally prohibited goods and services without the presence of any controls both on the current and capital accounts.[6]

It logically follows that once the government imposes restrictions and limitations on the holding of foreign exchange or on transferring it overseas, demand for alternative sources for that

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[1] Albert Makochekanwa, *Zimbabwe's Black Market for Foreign Exchange*, University of Pretoria Working Paper: 2007-13, July 2007 p 2(herein after ,Albert Makochekanwa, Zimbabwe's Black Market for Foreign Exchange)

[2] Derrese Degefe, 'The *parallel foreign exchange market and macroeconomic performance in Ethiopia'*, AERC Research Paper 107African Economic Research Consortium, Nairobi, May 2001 p15 (herein after, *Derrese Degefe, The parallel foreign exchange market and macroeconomic performance in Ethiopia*)

[3] Albert Makochekanwa, *Zimbabwe's Black Market for Foreign Exchange* p 2

[4] Derrese Degefe, *The parallel foreign exchange market and macroeconomic performance in Ethiopia* p 6

[5] *Id*., p.15

[6] Tefera Lemma, *Determinants of Parallel Foreign Exchange Market in Ethiopia*, National Bank of Ethiopia, Economic Research Department, August 2004,p 7(herein after, *Tefera Lemma, Determinants of Parallel Foreign Exchange Market in Ethiopia*)

currency emerge. Thus, government's inability to meet the demand for foreign currency and its interference in the operation of the market has a propensity to fuel the creation of parallel market for foreign exchange.[7] If the supply of foreign exchange in the official market is insufficient to satisfy the demand for it at the official exchange rate, excess demand for foreign currency is created in this market. If the concerned body of the government does not react to this excess demand, it will result in the emergence of the parallel foreign exchange market.[8]

Moreover in most cases, as part of the controls, exporters are required to surrender their export proceeds (partly or wholly) to the government within a specified period of time after which appropriation is instituted. On the other hand, importers are required to acquire import licenses that are granted to individuals by selected government officials and foreign currency is accessible to them in a limited number of officially authorized channels.[9]

After examining eight case studies of developing countries, Kiguel and O'Connell have shown that there is essentially two ways in which parallel foreign exchange market emerges and develops, i.e., the premium and volume of transaction become large.[10] First, parallel market emerges gradually in response to efforts to maintain an overvalued exchange rate. Overvalued exchange rate accompanied by foreign exchange controls, which were the characteristics of many developing countries, gives rise to parallel foreign exchange market. The typical example is where the economy faces a gradual worsening of the balance of payments as a result of expensive monetary and fiscal policies, which lead to sever inflation and overvaluation of the official exchange rate. The response of the government to correct the imbalance through tightening of macroeconomic policies and restrictions on the private sector's access to foreign exchange at the official rate would support the rise of the demand for foreign exchange in the parallel market.[11]

Parallel markets are common as a response to shortage, i.e., as means of venting excess demand. Incentives are created to acquire foreign exchange through illegal channels in order to supplement allocation of scarce imported goods. The main channels for illegal foreign exchange acquisitions

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[7] Albert Makochekanwa, *Zimbabwe's Black Market for Foreign Exchange p 2*

[8] Derrese degefa, *The parallel foreign exchange market and macroeconomic performance in Ethiopia'* p 15

[9] Nkurunziza D, Janvier, *Exchange rate policy and the parallel market for foreign exchange in Burundi*, African Economic Research Consortium Research Paper No 123, Nairobi, Kenya as cited by Albert Makochekanwa, *Zimbabwe's Black Market for Foreign Exchange* p 2

[10] Miguel A. Kiguel, Stephen A.O'connell; *Parallel exchange rates in developing countries*; *Lessons from eight case studies* , the world bank policy research department ,policy research working paper 1265, March 1994, p 6 [Herein after, Miguel and Stephen, *Parallel exchange rates in developing countries*;]

[11] *Id*.,p 9

are smuggling, under and over-invoicing of exports and imports as well as foreign in-ward remittance through the parallel market.[12] The factors, which stimulate parallel market activities, are taxes, regulations, prohibitions and bureaucratic corruptions, illegal trade of smuggling and contraband[13]

The existence of parallel foreign exchange market in Ethiopia could also be partly explained by the existence of control in the capital market and the preference of some dealers in illicit commodities operates outside the official market.[14] Though its exact time is not known with certainty, the majority hold that Parallel foreign exchange market in Ethiopia started or at least spread during the Dergue regime, arguably, due to adoption of restrictive foreign exchange control of the time.[15] Although the control of foreign exchange in Ethiopia dates back to 1942, the parallel foreign exchange market did not develop until the 1970s, perhaps due to stable macroeconomic environment.[16] Ethiopia's illegal parallel market for foreign exchange developed in the 1970s and expanded considerably during the 1980s in response to import controls and foreign exchange rationing implemented by the Derge regime.[17] The emergence of parallel foreign exchange market antedated the 1974 revolution. What differentiates the pre and post 1974 period is the motive, intensity and magnitude of the market as the factors that are responsible for the development of parallel foreign exchange market in Ethiopia were at minimum during the pre-1974 period as compared with the post-1974 period.[18]

In Derg regime, the total demand for US dollars in the auction system excludes those demanders of foreign exchange who do not fulfill the requirements set by the National Bank of Ethiopia for participation in a bid. The requirements include: a permanent import license, supplementary documents such as a copy of registered trade balance, the birr equivalent of the foreign exchange, and pro forma invoices indicating the price as well as transport expenses from at least two suppliers. The minimum bid allowed for participation in the auction was US$5,000 for the first three years after the adoption of the auction system, which was then raised to US$10,000 on 1

[12] Tefera Lemma, *Determinants of Parallel Foreign Exchange Market in Ethiopia*, p 4

[13]Derrese Degefe, *The parallel foreign exchange market and macroeconomic performance in Ethiopia, p.3*
[14] Tefera lemma, *Determinants of Parallel Foreign Exchange Market in Ethiopia, National Bank of Ethiopia ,p 2-3*
[15] Derrese Degefe, *The parallel foreign exchange market and macroeconomic performance in Ethiopia , p.10*
[16] *Id*.,p 16
[17] *Ibid*
[18] Befekadu Degefe ,The Exchange Rate of the Birr: Recent Experience and Policy Options, *Ethiopian Journal of Development Research,* 1994, Vol.13, No.1 As cited by Derrese Degefa *The parallel foreign exchange market and macroeconomic performance in Ethiopia* p 16

December 1995. All these and other restrictions together discouraged potential participants in the auction system, and partly stimulate demand for foreign exchange in the parallel market.[19]

In Ethiopia, like many other developing countries, widespread foreign exchange controls have resulted in the emergence of a parallel market for foreign currency which has been operating still now. And this shows inefficient pattern of resource allocation and exist for a relatively long period of time (not less than four decades), which may also continue to exist as long as there exist excess demand over the available supply and inefficiency in the foreign exchange market[20] As a result, the causes, effects and policy implications of black market in foreign exchange, in both developed and developing countries have attracted attention in recent years as the expansion of this market has been found to have adverse effects on the official economy.[21]

These effects are of particular concern to policy makers in developing economies, which are confronted with active parallel foreign exchange markets like Ethiopia. As a response for the adverse effects of parallel foreign exchange market, most developing countries including Ethiopia make the parallel foreign exchange market illegal and criminally liable. However making the market illegal also creates other adverse effects on the economy.

1.2 Statement of the Problem

In Ethiopia like many other countries, parallel foreign exchange market is an illegal activity. Article 20(1) of Proclamation no 591/2008 prohibits transactions in foreign exchange by person other than commercial banks or authorized dealers. Though it is considered illegal, the business of selling and buying of foreign exchange is being conducted illegally at various places in Addis Ababa.

Despite the fact that various attempts has been made by government to unify the parallel foreign exchange market with the official foreign exchange market through various gradual liberalization measures of devaluation, the former still continue to exist in Ethiopia. Even though, the actual share and magnitude of parallel market is not exactly known by empirical data arguably because it is conducted underground, it is prevalent in the capital city of Addis Ababa.[22] Some places are

[19] Derrese Degefa, *The parallel foreign exchange market and macroeconomic performance in Ethiopia ,* p13

[20] Tefera lemma, *Determinants of Parallel Foreign Exchange Market in Ethiopia,* P 9

[21] *Derrese Degefa, The parallel foreign exchange market and macroeconomic performance in Ethiopia,* p 1

[22] Tefera Lemma, *Determinants of Parallel Foreign Exchange Market in Ethiopia*, p.30

particularly identified as forex shops which are around Merkato *(*American Gibe and T/Himanot area), Kazanches in front of Hilton Hotel, around main Post office, behind Ethiopia Hotel and around Bole and Gandhi Hospital.[23]

Based on the previous assessment of NBE, the market (probably a single shop) can avail hundred thousands of US dollars at a time in a single transaction. This shows that the market is still important and can finance even big forex demand.[24] It is possible to estimate that the current volume of transaction is in billions of foreign currency [25]Studies shows that huge financial resources are flowing towards the parallel market.[26] However, this huge foreign exchange transaction is not regulated by Ethiopia's foreign exchange regulation. Ethiopia's criminal law makes the parallel foreign exchange market illegal; as a result the parallel market is excluded from the country's foreign exchange regulation. Hence, the parallel foreign exchange operators are not obliged to report the manner and the volume of transactions. Therefore, there is no transparent in flow and out flow of foreign currency in the country. The government has no any means of controlling their operation. The government is unaware of the volume of foreign exchange transactions being operated in the parallel market.

Because of this, the government loss control over the economy as more and more of the official transactions are diverted to the parallel market.[27] A billion dollar transaction takes place via informal channels particularly through parallel market and astonishingly 78 percent of the total remittance particularly private transfers passes through this channel.[28] As a result the foreign currency reserve is lower than it should be and the formal channel is in severe shortage of foreign currency. The Ethiopian economy is endangered because of the parallel market which dried up the availability of foreign currency in the formal channel.

Weak monetary policy which doesn't consider the billions dollars available in the parallel foreign exchange market is the other outcome of unregulated foreign exchange market. Money laundering, financing terrorism and capital flight are also the other potential fears which could exist in the unregulated foreign exchange market under the cover of parallel foreign exchange market.

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[23] Tefera Lemma, *Determinants of Parallel Foreign Exchange Market in Ethiopia*, p.30
[24] *.Id., p10*
[25] *Id*., p.30
[26] *Ibid*
[27] Derrese Degefe, *The parallel foreign exchange market and macroeconomic performance in Ethiopia*'p.6
[28]Desta G/hiwot: 'Informal channels raise red flag on forex earning' :online, The Ethiopian Herald; Posted September September 14/2017 http://allafrica.com/stories/201709140729.html (last accessed April 23/2018)

Studies show that since they are excluded from the country's foreign exchange regulation, parallel foreign exchange market entails various social and economic costs such as foreign currency shortage, loss of revenue, distortions in resource allocation, rent seeking, and weaken monetary policy instruments.[29] Market distortion is also the other outcomes of unregulated parallel foreign exchange market.[30] There cannot be effective monetary policy by excluding huge foreign currency operating in the parallel market. The absence of transparent parallel foreign exchange market results in weak monetary and other related economic policies. The country is currently found in a severe foreign currency shortage that is retarding investment and slowing down the overall economic activity of the country. The foreign currency reserve is lower than it should be since the foreign currency market has diverted its destination from the formal channel to the parallel market.[31]

The task of this paper is then to deal the Ethiopian regulatory regime on the problem and to identify its legal and regulatory issues.

1.3 Objectives of the Study

The general objective of this research is to critically explore and analyze the Ethiopian Parallel foreign currency market with a view to identify its major legal and regulatory issues and based on the finding to recommend appropriate measures. To attain the above general objectives, the researcher specifically intends to:

1. Explore the existing Ethiopian monetary laws in order to identify the major issues or problems on the parallel foreign exchange market
2. Asses the measures taken by the government and analyze their effectiveness
3. Investigate the proper legal regime that can avoid the problem
4. To forward the appropriate solution to tackle the problem

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[29] Nowak Michael, 'Quantitative Controls and Unofficial Market in Foreign Exchange: A Theoretical Framework', *IMF Staff Papers, (1984),* Vol.31, No.1 *as Cited by* Tefera Lemma*, Determinants of Parallel Foreign Exchange Market in Ethiopia, p.3*

[30] Solomon Abay Yimer, *Financial Market Development, Policy and Regulation: the International Experience and Ethiopia's need for Further Reform*, PhD Thesis, 2011 p 117[Herein after,Solomon Abay Yimer, *Financial Market Development, Policy and Regulation:*]

[31] Kennedy Abebe: 'Foreign exchange crunch; Now; then ,tomorrow '; online, Addis forune, Volume 18 No 905 https://addisfortune.net/columns/foreign-exchange-crunch-now-then-tomorrow/ (last Accessed May 5/2018)

1.4 Research questions

This research is conducted to answer the following central research question and sub-questions.

Central Research question:

How should the foreign exchange regulation of Ethiopia be enforced in the parallel market?

Sub-questions

1. How is the parallel market treated under the foreign exchange regulation of the country?

2. What are the impacts of excluding the parallel market from the ambit of foreign exchange regulation?

3. What are the ways of enforcing the foreign exchange regulation in the parallel market?

4. What are the lessons the country can draw in these regards from other countries?

1.5 Significance of the study

This study will have theoretical and practical importance. Theoretically, this research will have significant contribution in filling the knowledge gap on the Ethiopian parallel market as there is no formal study on the area before. Moreover, it will serve as inputs for the coming researches on the area**.** This paper will also have the following practical importance:

1. By indicating possible solutions on the problem, this research will contribute for policy and legislative reforms in the Ethiopian parallel foreign exchange market.
2. Since NBE is the primary regulatory organ in relation to Ethiopian foreign exchange policy, this research will have a lot for the efficiency of its regulation.
3. Assessing and examining the regulatory issues of parallel foreign exchange market will assist Ethiopia's WTO accession process as it is part and parcel of Ethiopian foreign exchange market.

1.6 Literature Review

The issue of parallel foreign exchange market is not a recent phenomenon in Ethiopia. Despite this fact however, the issue is not well researched yet. Though there are some studies on

Ethiopia's parallel foreign exchange market, their analysis is from the economics aspect not from its legal aspect.

The first author as to the researcher knowledge in the related area is Zelealem Yiheyis .His journal is titled as "The Economic Determinants of the Parallel Currency Premium: Evidence from Selected African Countries" and Ethiopia was one of the selected countries in the study, which is published in the journal of economic development, in December 1998. The purpose of the paper is developing a model which integrates the flow and portfolio motives for holding parallel currency on the demand side and a supply equation that recognizes the dependence of the supply of foreign exchange on the parallel currency premium, with a view to identify the primary economic determinants of the latter in selected African countries. The paper documents the relevance of both the flow and portfolio motives in the determination of the parallel currency premium in the sample countries based on economical analysis. [32] The objective of this paper has been to investigate the pattern of the parallel currency premium in a sample of sub-Saharan African countries with a view to identify their primary economic determinants. The paper provided an overview of the behavior of the premium, which were characterized by substantial cross-sectional and time wise variability. An econometric model which recognizes the flow and stock aspects of the parallel exchange market was formulated and its different variants estimated.[33]

The other author in the related topic is Derrese Degefe whose title is "parallel foreign exchange market and macroeconomic performance in Ethiopia" in May 2001.The paper looks into the changes of the parallel premium in relation to the movements of macroeconomic variables. In his paper he dealt the determinants of the parallel premium based on a stock-flow model and he examined the impact of the parallel premium on merchandise exports and investigated whether inflation Granger causes the parallel exchange rate. Most of his analysis depended on Economic theory. [34]His paper deals the determinants of the parallel premium for foreign exchange and the effect of parallel premium on merchandise exports. He concludes that that the parallel premium

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[32] Zelalem Yiheyis, 'The Economic Determinants of the Parallel Currency Premium: Evidence from Select African Countries', *Journal of Economic Development,* December 1998 ,Volume 23, Number 2, 161- 178 at p 161[Herein after Zelalem Yiheyis, The Economic Determinants of the Parallel Currency Premium]

[33] *Id., p 176*

[34] *Derrese degefe ;'The parallel foreign exchange market and macroeconomic performance in Ethiopia,*p 5

has significant negative effect on merchandise exports in both the long run and the short run. This implies that the parallel premium has considerable impact on the export sector in general and on merchandise exports in particular. On the other hand, real money balance, real exchange rate and foreign aid (grants) are found to be the main determinants of the parallel premium in Ethiopia in the long run, while terms of trade are found to have a significant negative effect on the premium only in the short run. Furthermore, inflation is generally found to cause the parallel exchange rate for the period under consideration. His conclusions was that, constraints to the functioning of the official foreign exchange market of Ethiopia need to be eliminated through further liberalization so as to avoid the repercussions of the parallel premium on macroeconomic variables that in turn could initiate a chain of further reactions.[35] The writer only discussed the determinants of parallel foreign exchange premium from the Economic aspect.

The other author is Tefera Lemma, who was one of the staffs in National bank of Ethiopia. His paper was titled as “Determinants of parallel foreign exchange market in Ethiopia’ which was written in August 2004. His paper provides systematic analysis in factoring out the main determinants of the parallel foreign exchange market in Ethiopia. The purpose of the paper is to provide some empirical documentation on the determinants of the parallel foreign exchange market under both fixed and “floating” rate arrangements.[36] His paper mainly focused on the determinants of parallel foreign exchange market in Ethiopia and analyzed the determinants with purely economic theory.

As discussed above, the existing literatures on the Ethiopia’s parallel foreign exchange market are conducted either from Economic analysis perspectives or confined in determining the determinants of parallel foreign exchange market. Yet, to the best of the researcher’s knowledge, comprehensive and extensive studies have not been carried out in Ethiopia’s parallel foreign exchange market from the legal aspect. The regulatory regime of the parallel foreign currency market as well as the measures to tackle the problem is not dealt by previous studies. Hence, this research will entertain the Ethiopian parallel foreign exchange market from the legal perspective.

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[35] *Derrese degefe ;The parallel foreign exchange market and macroeconomic performance in Ethiopia,*p *33*
[36] Tefera Lemma*, Determinants of Parallel Foreign Exchange Market in Ethiopia, National Bank of Ethiopia,* p 27

1.7 Scope of the study

The scope of this study is largely confined to legal and regulatory issues of parallel foreign exchange market in Ethiopia. It tries to explore and assess Ethiopia's laws governing parallel foreign exchange markets and analyze the parallel market under the Ethiopia's foreign exchange regulation. This Research does not deal with all aspects foreign exchange regime of Ethiopia.

The area and the data collection scope of this study is confined to Addis Ababa and does not include the regional governments for the reason that the parallel foreign exchange market is largely practiced in Addis Ababa and the issue of foreign exchange constitutionally lies under the power of Federal Government.

1.8 Limitation of the Study

Lack of academic materials and literatures on Ethiopia's parallel market for foreign exchange was a challenge. The researcher tries to overcome or at least reduce the above problem through reference to foreign literatures. The data for the empirical part of the study through interview from individual parallel market operators was somehow difficult as they were not willing to give full-fledged information for the reason that they are illegal under the current legal regime. Moreover it was difficult to get all directives of NBE in their website.

1.9 Research Methodology

The general objective of the study is exploring the Ethiopian legal frameworks on the parallel foreign exchange market and to analyze the legal and the regulatory issues surrounding it. In order to achieve these objectives, the researcher used doctrinal and empirical (socio-legal) research through qualitative methodology. The researcher mainly employs doctrinal qualitative legal research since the main issues and objectives of the study is exploring the existing laws and identifying the regulatory issues on the parallel foreign exchange market. Exploring the existing laws for an in-depth understanding of the law and its regulatory issues lead the researcher to use Qualitative methodology.[37] The empirical part is employed for supplementing the findings of the earlier.

[37] *SCOTT W. VANDERSTOEP, DEIRDRE D. JOHNSTON*, *Blending Qualitative and Quantitative Approaches,2009, P 224(herein after , SCOTT W. VANDERSTOEP, DEIRDRE D. JOHNSTON)*

1.9.1 Population, Sample size and Sample techniques

In the doctrinal part, the researcher analyzes all laws, policy documents and literatures concerning the parallel foreign exchange market as the main concern of the paper is exploring the legal regime and identification of legal as well as regulatory issues of Ethiopian parallel foreign exchange market.

In the empirical part of the study, the researcher employed non-probability sampling in selecting key respondents in the NBE and private banks. The researcher used same sampling in selecting respondents from parallel market dealers and business peoples. Hence during the empirical data collection, purposive sampling is employed to gather the information necessary for the research work. The nature of the study also calls for careful and purposive selection of respondents. Therefore the researcher was selective in choosing respondents from the National Bank of Ethiopia, private banks, parallel market dealers and also from business peoples.

Regarding the sample size of the study, as this research employ qualitative study, it may be difficult to determine the exact sample size in advance because the inquiry goes on until the data or the information is saturated or at the point of redundancy. The size of a qualitative sample is considered sufficient when the criterion of redundancy is met.[38] So the researcher continued gathering information until the empirical data was saturated.

1.9.2 Data Types and Collection Tools for Doctrinal Research

For the doctrinal part of the research, both primary and secondary data was collected, and analyzed. **The primary data:** Include domestic laws including constitution, proclamations, regulations, directives of NBE and cases as well as International and Foreign laws if any.

The secondary data: Include monetary policy documents of NBE, Annual Reports of NBE official reports, and Publications such as books, articles, periodicals and commentaries serve as secondary data. Doctrinal research needs tools and skills of identifying the sources of law and relevant legal materials. [39] In doing so different finding tools will be employed by the researcher such as 'codes', digests, encyclopedias, internet and etc. that facilitate the access of law and legal materials to the legal researcher.

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[38] *SCOTT W. VANDERSTOEP, DEIRDRE D. JOHNSTON, P 188*

[39] *Edited by Mike Mc Conville and Wing Hong Chui, Research Methods for Law, Edinburgh University Press Ltd ,2007 ,Page 19,*

1.9.3 Data Types and Collection Tools for Empirical Part of the Study

The Primary empirical data was collected through semi-structured face to face interview and observation. And for the secondary data of the empirical study, document analysis through finding tools was employed.

Interview: The researcher tries to identify the legal and regulatory issues by interviewing key informants from NBE, private banks, parallel market dealers, and from some business peoples. In interview, the researcher conducted semi structured face-to-face interview having pre-determined questions based on the concern of the paper. Semi-structured interview is preferred in this study since the interviewees are more of professionals from NBE and Private Banks. It is preferred because of its flexibility in exploring the issues in detail and it is less time consuming and more pre-planned than the fully structured interview.

Observation: The researcher tries to strengthen or corroborate the information obtained in the interview by observing the main areas where the parallel market is largely transacted. Observation was used as a supportive or supplementary method for the data collected in interview.

Data Analysis: The researcher uses legal and document analysis for the doctrinal part of the study and uses qualitative data analysis technique for the empirical data.[40]

1.10 Organization of the Paper

The paper has five chapters, which in turn divided into sections and sub-sections. The first chapter is an introduction that describes background of the study, statement of research problem, research objectives, research questions, research methodology, scope of the research, significance of the study, and organization of the study. Chapter two of the paper deals the treatment of the parallel market under the Ethiopian foreign exchange regulation in which the historical aspect of the parallel foreign exchange market, the supply and demand for parallel market and different foreign exchange regulations have been discussed. Chapter three discusses the effects of excluding the parallel market from Ethiopia's foreign exchange

[40] *Edited by Mike Mc Conville and Wing Hong Chui, Research Methods for Law, Edinburgh University Press Ltd ,2007 ,Page 19,*

regulation. Chapter four deals ways of enforcing Ethiopia’s foreign exchange regulation in the parallel market. Finally chapter five will have conclusions and recommendations.The experiences of other countries on the parallel market also included in each chapter of the paper.

Chapter Two

Treatment of the Parallel Market under the Foreign Exchange Regulation

2.1 Definition

The definitions given for the parallel and official market vary across the literatures.[41] It sounds useful to see the meaning of these terms as they used in this paper. Accordingly, each market is conceived as a set of commercial activities characterized by the following features.[42]

Official market: is a transaction by authorized (licensed) commercial banks, and works in compliance with the official foreign exchange rules and regulations set by the monetary authority. Whereas **Parallel market** is a transaction by unauthorized (unlicensed) individual/s and/or institutions in non compliance with the official foreign exchange rules and regulations set by the monetary authority. [43]

According to these definitions, the parallel market includes all private dealers who operate without official licensing to do business in foreign exchange as well as those private firms/institutions who are licensed to operate as part of legal trading institutions but who at the same time are involved in the illegal parallel market foreign exchange trade.[44]

The term “black market for foreign exchange” which is usually used by many economists to distinguish the official foreign exchange market from parallel market, is not used here as its meaning is not synonyms with the parallel market. “Black” market refers markets for prohibited goods such as narcotics, cocaine etc for which no legal market exists in the economy. Black markets are markets, which are illegal, and detection carries penalties. So the illegal market which has no alternative official market is not considered as parallel market.[45] Therefore,

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[41] Tefera Lemma, *determinants of parallel foreign exchange market in Ethiopia*, p 6
[42] *Ibid*
[43] *Ibid*
[44] *Ibid*
[45]Lindauer David**,** ‘Parallel, Fragmented, or Black? Defining Market Structure in Developing Countries’ *World Development*, 1989- V.17. No.12 as cited by Tefera Lemma, *determinants of parallel foreign exchange market in Ethiopia*, p 7

throughout this paper the researcher use “parallel” market instead of “black” to represent the unofficial foreign exchange market since foreign exchange is a legal asset. [46]

2.2 The Historical aspect of the parallel foreign exchange market in Ethiopia

In Ethiopia, like many developing countries, widespread trade restrictions and foreign exchange controls have resulted emergence of a parallel market in foreign currency.[47] Although the control of foreign exchange in Ethiopia dates back to 1942, the parallel foreign exchange market did not develop until the 1970s, perhaps due to stable macroeconomic environment.[48]

In the Imperial era, except for some essential consumer items, imports were free from licensing or other quantitative restrictions and exporters were required to surrender their foreign exchange to commercial banks at the prevailing official exchange rate. The existence of macroeconomic stability and a relatively liberal trade regime probably reduced misalignment of the actual exchange rate from its equilibrium in this regime.[49]

During the pre 1974 phase, the foreign exchange reserve of the country was sound and there was a thin and insignificant parallel foreign exchange market with insignificant exchange rate. The early 1970s official and parallel market exchange rates were the same. There were even cases where the parallel market rate was lower than the official rate, especially for small amounts of hard currency.[50]

The exchange controller of the National Bank of Ethiopia had the authority to allocate the requested foreign exchange on a daily basis provided that all the necessary procedures were followed. During the peak foreign exchange earnings season (October to February) the quantity supplied was more or less equal to the amount demanded. [51]

When deciding to make a foreign exchange allocation, the exchange controller considered the available foreign exchange and the expected earnings; the latter were estimated by taking into account the export permits issued. During the off-peak season, foreign exchange allocation was sometimes delayed for a few days to two weeks, depending on the amount requested and on the

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[46] Tefera Lemma, *determinants of parallel foreign exchange market in Ethiopia* p 7
[47] *Id* p 9
[48] *Derrese Degefe, ‘The parallel foreign exchange market and macroeconomic performance in Ethiopia’, p16*
[49] *Id* p 12
[50] Asmerom Kidane,*Exchange rate policy and Economic reform in Ethiopia,* Africa Research consortium, March 1997 P 21*[Herein after* Asmerom Kidane*, Exchange rate policy and Economic reform in Ethiopia]*
[51] *Id* p 7

expected earnings. A substantial portion of the allocation was made to the private sector.[52] Although the exact time for the emergence of parallel foreign exchange market in Ethiopia is not clearly known, the parallel exchange market in Ethiopia is not a recent phenomenon. It's origin date back to four decades.

Given the stable macroeconomic condition during pre 1974 period, consensus has already been reached that the prominence and importance of the market began during the Derg regime as it was characterized by intensified exchange control and prohibitions.[53] During this time, official import capacity declined, importers came to rely on the parallel market for foreign exchange, which resulted in further depreciation of the Birr on the parallel market. In effect, the parallel and official exchange rate widened. The largest suspected sources of illegal foreign currency earnings were smuggled exports, unrecorded tourist expenditure and private inward transfers.[54]

Until 1992, particularly during the Derge regime, Ethiopia's foreign exchange regime has been characterized by administrative control and fixed rate with surrender requirement, exchange rationing and currency inconvertibility. The exchange control regulation required all Ethiopian to surrender all foreign exchange to the National Bank of Ethiopia in exchange for domestic currency at the official fixed exchange rate. The fixed exchange rate together with high inflation rates resulted in the appreciation of the Birr in the official market. This in turn brought a decline in export performance and reduced import capacity. As legal import capacity declined, smuggling and Franco-valuta imports emerged to meet the additional demand for imports, which in return created a parallel foreign exchange market to finance both imports and other foreign exchange payments.[55]

At that time foreign exchange control regulation no 1/1977[56] controlled the foreign exchange transactions of the time. In the regulation, under Article 2(4), Authorized banks have been defined as any bank authorized by the National bank to engage in transactions of foreign exchange. This implies that it is not permitted to engage in foreign exchange transactions other than those authorized banks.

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[52] Asmerom Kidane, *Exchange rate policy and Economic reform in Ethiopia* ,P 7

[53]Tefera Lemma, *Determinants of Parallel Foreign Exchange Market in Ethiopia,* P 10

[54] *Ibid*

[55] *Id .,p 9-10*

[56]Foreign Exchange Control Regulation, National Bank of Ethiopia, Legal Notice No.01/1977[herein after, Regulation 01/1977]

During the second phase (1974-1983), the acquisition of import licenses did not guarantee the acquisition of all or some of the foreign exchange requested. During this period the government proceeded with the policy of nationalization of private manufacturing, trade and service establishments, including the external trade sector. At the same time foreign exchange earnings declined rapidly, nationalized enterprises could not get all they wanted and excess capacity began to prevail. Imports of basic necessities were reduced further. The foreign exchange controller could not meet the demand for foreign exchange by importers and the time between application for foreign exchange and the authorization (if any) took several weeks. The outright rejection of applications became quite common. For those whose applications were favorably considered, the amount authorized was less than requested. There were two reasons for this; the first one was the need to "equitably" distribute whatever foreign exchange was available for dispersal; second was the many incidents of over invoicing. By the end of this period the national bank had established a market surveillance division to control such practices.[57]

Ethiopia's illegal parallel market for foreign exchange developed in the 1970s and expanded considerably during the 1980s in response to import controls and foreign exchange rationing implemented by the Derge regime. The emergence of parallel foreign exchange market antedated the 1974 revolution. [58]

At the same time foreign exchange earnings declined rapidly, nationalized enterprises could not get all they wanted and excess capacity began to prevail. Imports of basic necessities were reduced further. The foreign exchange controller could not meet the demand for foreign exchange by importers and the time between application for foreign exchange and the authorization (if any) took several weeks. The outright rejection of applications became quite common. For those whose applications were favorably considered, the amount authorized was less than requested. There were two reasons for this; the first one was the need to "equitably" distribute whatever foreign exchange was available for dispersal; second was the many incidents of over invoicing. By the end of this period the national bank had established a market surveillance division to control such practices. [59]

What differentiates the pre and post 1974 period is the motive, intensity and magnitude of the market as the factors that are responsible for the development of parallel foreign exchange

[57] Asmerom Kidane*, Exchange rate policy and Economic reform in Ethiopia, p 8*

[58] *Ibid*

[59] *Ibid*

market in Ethiopia were at minimum during the pre-1974 period as compared with the post-1974 period.[60]

During the third phase (1984-1991), the Economic Policy Department of the Workers' Party of Ethiopia, took over the administration and allocation of most foreign exchange requests. The activity of the Exchange Control Department of the bank was confined to disbursing funds allocated by the party committee and to authorizing the allocation of the invisibles alone. The latter constituted less than 5% of the total allocation.

The foreign exchange regulations of Ethiopia that have been in operation from 1982 -1997 spell out the procedures for transactions in foreign exchange, holding of foreign exchange, surrender and replenishment of foreign exchange, approval of exports of goods and services, capital remittances and payments for imports to Ethiopia. The regulations state that commercial banks cannot hold foreign currency and that they cannot acquire shares, stocks or bonds denominated in foreign currencies. No Ethiopian national resident in the country can maintain a bank account abroad, and every transaction involving hard currency must be made through the National Bank of Ethiopia. A large percentage of foreign exchange allocated by the national bank is for payments of imports. An importer has to produce a valid foreign trade or import license, and goods to be imported must be free from import prohibition. There are detailed forms to fill, including suppliers' invoices, the terms of payments and the provision of adequate insurance. The process is so detailed and time consuming that by the time the application is approved and payment authorized, the original invoice may be outdated and a new process initiated.

Besides foreign exchange allocations for import, there are allocations for "invisibles" such as salary transfers by foreign employees who are entitled to remit 30% of their net earnings. Students with valid visa who leave Ethiopia for study abroad are allowed foreign exchange up to the equivalent of birr 500; students and trainees sent abroad by the Ethiopian government may obtain foreign exchange upon the request of the concerned government department.

Other foreign exchange allocation like the allocation of foreign exchange for import, require detailed administrative procedures and various restrictions, leading to substantial costs in terms of money, time and labor.

[60] Befekadu Degefe,;'The Exchange Rate of the Birr: Recent Experience and Policy Options', *Ethiopian Journal of Development Research,* (1991) Vol.13, No.1 as cited by Derrese Degefe*, The parallel foreign exchange market and macroeconomic performance in Ethiopia,* p 12

During this phase, in line with the marxist orientation of the government, the amount of foreign exchange allocated to the private sector by the party committee was insignificant and hard to predict. This led to an ever-growing parallel foreign exchange market and shortages of basic imported items such as pharmaceuticals, baby foods, spare parts, various inputs and the like. At the same time, controls and restrictions began to tighten. Cognizant of the fact that there was a severe shortage of basic imports, the government authorized private importation of goods through the "Franco Valuta" approach. Under this procedure individuals were allowed to import authorized consumer goods, spare parts, etc., through "own funded" foreign exchange. Import licenses were still required, and the tax on such importable increased. The limited supply of foreign exchange and the strengthening of foreign exchange controls and trade restrictions during the 1980s resulted in the substantial growth of the parallel exchange market.[61]

As a result, the informal sector began to flourish; the parallel market premium began to widen; remittance from Ethiopians residing abroad ceased to come through the normal channels (the banks); smuggling of exports became the order of the day. The foreign exchange earnings of the government began to decrease. Ethiopians abroad realized that there was a shortage of imported consumption items and instead of remitting currency, they began to smuggle such items into the country as they began to bring high-value goods into the country rather than remitting currency.

As a result, the country was flooded with many imported consumption items. Housewives, government employees and others became informal traders. Making "quick money" was the motto of informal traders, and the informal sector became dominant.

During all these periods, cumbersome procedures governed transactions in foreign exchange. Traders wishing forex for imports must go through a process of application and documentation that is time consuming and by the time the application is approved and payment authorized the original invoice may be out of date.[62].

The significance of the illegal parallel market for foreign exchange grew to the extent of impairing the operations of the official foreign exchange market during the post-1974 years, and particularly since 1981. It is also argued that the parallel foreign exchange market activities in Ethiopia have been important at various times in attracting traders, dealers and others who wish to export funds in excess of permitted limits. Parallel market dealings became hectic, as the

[61] Asmerom Kidane *,Exchange rate policy and Economic reform in Ethiopia,* P 8-10
[62] *Id* ,p 39

intensifying political instability pushed money out of the country following the replacement of the Ethiopian dollar by Ethiopian birr in September 1976.[63]

Post 1991

As discussed above ,the Derge regime responded to the falling competitiveness of legal exports and to smuggling activities,by tightening its control regime through strict rationing of foreign exchange; by prohibiting the domestic trade of many exportable goods (notably coffee) and by providing export subsidies for loss-making state-owned exporters. In the history of the Derge regime, significant changes occurred in the exchange and trade system during 1977.[64]

The country's exchange rate policy did not change until the massive devaluation of the Birr in October 1992. In subsequent years, current account was liberalized and import licensing requirements and other forex transaction activities such as opening retention account and export licensing were transferred to commercial banks; forex bureaus were established in 1996 to buy and sell foreign exchange in the retail market at freely negotiated rates; franco-valuta imports were banned and concerted efforts were made to halt illegal trade. All these and other related measures have contributed to a sharp reduction of the parallel premium, which reached less than 2 percent by the end of 2002/03.[65]

Realizing the negative effect of an over-valuation of the birr on the country’s trade balance and, hence, on balance of payments, the Transitional Government of Ethiopia, (TGE) devalued the birr seven times with an official exchange rate gradually reaching 6.25 birr per US dollar before the date of unification in the late 1995. [66]

The TGE also introduced the auction for foreign exchange in May 1993 in an effort to liberalize the foreign exchange market so as to achieve market determined exchange rate. The belief at the centre of successive devaluations of official exchange rates and the adoption of the auction system is to attract foreign exchange in the parallel market back to the official line and thereby strengthen official reserves. From May 1993 up to the unification of the official and the auction exchange rates on 25 July 1995, the exchange rate was partly determined by government decree (applicable to the official rate) and partly by quasi-market forces (applicable to the auction rate)

[63] Cowitt, P.,World Currency Yearbook, Various Issues, 1989, as cited by Derrese Degefa, *The parallel foreign exchange market and macroeconomic performance in Ethiopia,* p 16

[64] Derrese Degefa, *The parallel foreign exchange market and macroeconomic performance in Ethiopia,* p16

[65] Tefera Lemma, *Determinants of Parallel Foreign Exchange Market in Ethiopia,* P 10

[66] Derrese Degefe*, The parallel foreign exchange market and macroeconomic performance in Ethiopia* , p 12

as represented by auctions. Since the date of unification, the exchange rate of the birr against the US dollar and the resultant cross-rates has been determined only through the auction system. From the date of unification up to the present day, we have a quasi-market determined exchange rate.[67]

As components of the stabilization-cum-liberalization program adopted in 1992, the government of Ethiopia abolished

• Taxes on exports (except coffee) in December 1992, and in August 1993 reduced differences between tariff rates.

• All export subsidies to Ethiopian industries in December 1992 by replacing them with an incentive that allows duty-free importation of raw materials.

• Negative list imports of the National Bank of Ethiopia on February 3, 1995.

• Franco valuta imports in July 1996.[68]

As expressed above, the Ethiopian auction market for foreign exchange was established on 1 May 1993. Although there are two ways in which the exchange rate can be determined through the auction system, i.e., discriminatory and a competitive auction system, the government of Ethiopia chose a discriminatory in which foreign exchange is allocated to winners of bids at their respective bid prices until the total foreign exchange made available is exhausted.[69]

The total demand for US dollars in the auction system excludes those demanders of foreign exchange who do not fulfill the requirements set by the National Bank of Ethiopia for participation in a bid. The requirements include: a permanent import license, supplementary documents such as a copy of registered trade balance, the birr equivalent of the foreign exchange, and pro forma invoices indicating the price as well as transport expenses from at least two suppliers. The minimum bid allowed for participation in the auction was US$5,000 for the first three years after the adoption of the auction system, which was then raised to US$10,000 on 1 December 1995. All these and other restrictions together discourage potential participants in the auction system, and partly stimulate demand for foreign exchange in the parallel market.[70]

[67] Derrese Degefe, *The parallel foreign exchange market and macroeconomic performance in Ethiopia* , p 12-13
[68] *Ibid*
[69] *Ibid*
[70] *Id.,* p 13

Moreover Prior to February 1995, foreign exchange was not made available through official markets for negative list imports, which include wild animals, meat, butter, fish, oilseeds, sugar and honey, coffee, tea, spices, alcoholic beverages, leather, chat, beeswax, cotton based fabrics, TV sets, radios, private autos, shoes, watches, and jewellery. Those who have smuggled these goods into the country used the parallel foreign exchange market.[71] Moreover, licensed importers whose demand for foreign exchange was not met in the official market at the prevailing official auction exchange rate use the parallel foreign exchange market.[72] Of course, as pointed out earlier, the parallel market for foreign exchange continues to function despite the efforts of the government to abolish it.[73]

Notwithstanding variety of sources of supply for foreign exchange in the parallel market, there is in general a dominant source at each time and in each country. In Ethiopia, the dominant sources of supply of foreign exchange for the parallel market are largely contraband exports (smuggled exports) of goods and services and unofficial private transfers. On the other hand, legal and illegal imports, capital flight motive, and residents' travel abroad are generally the principal sources of demand for foreign exchange. Contraband importers and invisible payments such as payments for medical, educational and travel services abroad are the dominant sources of demand for foreign exchange in the parallel foreign exchange market of Ethiopia. A large portion of franco valuta imports was also financed with the foreign exchange obtained on the parallel foreign exchange market before it was banned by the government in July 1996.[74]

In order to overcome the impact of an active parallel foreign exchange market on economic growth and in an attempt to finally unify the official and the parallel exchange rates, many sub-Saharan African countries have been trying to reduce the parallel premium through devaluation and the adoption of auction exchange rate systems. Similarly, Ethiopia started implementing a foreign exchange liberalization program with the massive devaluation of exchange rate of the birr in October 1992 and the establishment of the auction system (which has been mainly financed by the inflow of foreign grants and loans) in early 1993. The objective was to integrate the illegal parallel market for foreign exchange into the formal economy.[75]

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[71] Derrese Degefe*, The parallel foreign exchange market and macroeconomic performance in Ethiopia* , p15

[72] *Ibid*

[73] *Id*.,p 14

[74] *Id.,*p 17

[75] *Id.,*p 8

Despite all these efforts undertaken, the parallel foreign exchange market is still active.[76] This inefficient pattern of resource allocation for a relatively long period of time (not less than four decades) also continue to exist as there exist excess demand over the available supply and inefficiency in the foreign exchange market.[77]

2.3 Current governing laws and regulatory organ of Foreign exchange market

There are legal and policy documents to regulate foreign exchange system of the country. Constitution, primary legislation (Proclamations), secondary legislation (regulations and directives) governs foreign exchange transaction in Ethiopia. Under the primary legislation, Proclamation No.591/2008, Criminal code[78], Anti-money Laundering and terrorism Financing Proclamation, have relevancy in regulating currency exchange. Various directives of NBE, the policy document showing the monetary policy framework of Ethiopia, different annual reports of NBE, and IMF Consultation document with Ethiopia, have some bearing on foreign exchange regime of Ethiopia.

2.3.1 Constitutional Framework

The 1995 FDRE Constitution introduced Federal state structure by which power of the state is constitutionally divided between the Federal government and Regional governments. The Constitution vested the Federal Government with power to "*…administer the National Bank, print and borrow money, mint coins, regulate foreign exchange and money in circulation.*"[79] Thus, according to the Ethiopian Constitution, regulation of matters related to currency in general and foreign exchange in particular falls under the exclusive ambit of Federal government power.

The Ethiopian Constitution, Article 55(10) entrusts the House of People Representative with power and duty to enact laws on matters related to the local currency, the administration of the National Bank, and foreign exchange. With regard to enforcement organs, article 77(4) of the

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[76] Tefera Lemma*, Determinants of Parallel Foreign Exchange Market in Ethiopia,* P 11
[77] *Id* p 9
[78] The Criminal Code of the Federal Democratic Republic of Ethiopia, 2004, *Federal Negarit Gazetta*, Proclamation No. 414, 9th year of May, 2005, Article 346, 348, 778, 785 [Herein after The Ethiopian Criminal Code]
[79] Constitution of Federal Democratic Republic of Ethiopia, 1995, Federal Negarit Gazetta, Proc.No.1, 1st year, No.1, Article 51(7) [Here in after FDRE Constitution]

Constitution as well as proclamation No.591/2008 empowers the Council of Ministers and National Bank of Ethiopia to regulate foreign exchange matters.

2.3.2. Primary and Secondary Legislations on Ethiopian Currency Exchange

Article 55(10) of the Constitution empowers HPR to enact primary laws on currency and foreign exchange matters. However HPR does not enact separate and comprehensive laws on foreign exchange matter. Rather foreign exchange matters are included under National Bank of Ethiopia establishment Proclamation No.591/2008. This does not however mean that Ethiopia does not have primary legislation on foreign exchange.[80]

National Bank of Ethiopia establishment Proclamation No.591/2008, Regulation No.01/1977 and Directives of NBE are the major legal frameworks that set legal standards and regulation on foreign exchange transaction in Ethiopia. Proclamation No.591/2008 is a legal basis for foreign exchange transactions as well as power and duty of the regulatory organ. The detail matter on the foreign exchange is found on the directives of NBE.[81]

The National Bank of Ethiopia Establishment (as Amended) Proclamation No. 591/2008[82] is the primary legislation that defines foreign currency, foreign exchange and foreign exchange transactions in Ethiopia as well as power and duties of the regulatory organ.

The proclamation provides legal framework on regulation of foreign exchange market in Ethiopia. However, provisions of Proclamation No.591/2008 on regulation of foreign exchange are inadequate since it delegates most matter to NBE with a great deal of discretionary power. The National Bank of Ethiopia is mandated to issue foreign exchange directives to control the transactions and allocation of foreign exchange resource. The foreign exchange regime governs

[80] Eyader Teshome , *legal and regulatory issues of the Ethiopian foreign exchange regime and transactions*, LLM thesis , Bahir dar University; law faculty 2017,[Unpublished] p 65, {herein after Eyader Teshome, Legal and regulatory issues of the Ethiopian foreign exchange regime and transactions}

[81] *Ibid*

[82] See , Eyader Teshome, *Legal and regulatory issues of the Ethiopian foreign exchange regime and transactions*, p 66, The establishment proclamation was issued on 11 August 2008 to reassure the continuous existence of the National Bank of Ethiopia established by Order No. 30/1963 and to legally govern it. Before enactment of this Proclamation, NBE was regulated by the repealed Monetary and Banking Proclamation No. 83/1994.

transactions requiring international payments by commercial banks including exchange requirements for importers, exporters, foreign exchange dealers and individuals.[83]

There are in fact some basic legal provisions that set forth various legal standards on currency exchange. Among those provisions, Article 20(1) of the establishment proclamation no 591/2008 will be the main concern of the paper.

2.4 National Bank of Ethiopia (NBE): The Regulatory Organ

National Bank of Ethiopia,[84] as central bank of the country, is the primary and most important organ assigned with powers and responsibilities to regulate various aspects of currency exchange in Ethiopia.

National Bank of Ethiopia Establishment (as Amended) Proclamation No. 591/2008 states the objectives, powers and duties of the Central bank of Ethiopia, i.e. NBE, on matters of currency, exchange rate policy and foreign exchange transactions. National Bank of Ethiopia, as central bank of the country, is the primary and most important organ assigned with power and responsibility to regulate various aspects of currency exchange in Ethiopia. Moreover, NBE is authorized to monitor foreign exchange transactions of banks, insurance companies and other financial institutions through on-site inspection and off-site surveillance.[85]

Though National Bank of Ethiopia, as central bank of the country, is the primary and most important organ assigned with power and responsibility to regulate various aspects of currency exchange in Ethiopia, there are also other organ that have either direct or an indirect regulatory roles. Markedly, organs of government with regulatory role includes, but not limited to, the

[83] Foreign exchange regulations and directives in Ethiopia, https://www.2merkato.com/articles/industry/871-foreign-exchange-regulations-and-directives-in-ethiopia,

[84] See Foreign exchange regulations and directives in Ethiopia, https://www.2merkato.com/articles/industry/871-foreign-exchange-regulations-and-directives-in-ethiopia,The National Bank of Ethiopia was established in 1963 by Proclamation 206 of 1963 and began operation in January 1964. The establishment of the new organization was aided by U.S Department of State emissary, Earle O. Latham, who was the first Vice President of the Federal Reserve Bank of Boston. Following the proclamation, the National Bank of Ethiopia was entrusted with the following responsibilities: To regulate the supply, availability and cost of money and credit, to manage and administer the country's international reserves, to license and supervise banks and hold commercial banks reserves and lend money to them, to supervise loans of commercial banks and regulate interest rates, to issue paper money and coins and to act as an agent of the Government.

[85] National Bank of Ethiopia Establishment (as Amended) Proclamation, 2008, *Federal Negarit Gazetta*, Proc. No.591, 14th Year No 50., Article 20(5)[Herein after; proc 591/2008]

Ethiopian Revenue and Custom Authority, Ethiopia's Financial Intelligence Centre (FIC) , Ministry of Finance and Economic Co-operation, Investment Bureau, etc. [86]

The purpose of the National bank of Ethiopia according to Article 4 of the establishment proclamation is to maintain stable rate of price and exchange, to foster a healthy financial system and to undertake such other related activities that are conducive to rapid economic development of Ethiopia.

In attempt to accomplish these objectives, Article 5 of Proclamation No.591/2008 entrusts the National Bank with powers and duties:

- ✓ To [mint] coin, print or cause to be coined, printed and circulated the legal tender currency;
- ✓ To regulate and determine the supply and availability of money and credit as well as the applicable interest rates and other charges;
- ✓ To formulate and implement exchange rate policy;
- ✓ To manage and administer the international reserves of Ethiopia;
- ✓ To set limits on gold and silver bullion and foreign exchange assets which banks and authorized dealers can hold;
- ✓ To set limits on the net foreign exchange position and on the terms and the amount of external indebtedness of banks and other financial institutions;
- ✓ To act in compliance with international monetary and banking agreements of Ethiopia and represent Ethiopia in the International Monetary Fund and other international financial organizations formed by central banks;

Moreover, NBE is authorized to monitor foreign exchange transactions of banks, insurance companies and other financial institutions through on-site inspection and off-site surveillance.[87]

The objectives of monetary policy in Ethiopia are, among others, maintenance of price and exchange rate stability and ensuring the safety and soundness of the financial system within the broader macroeconomic policy of attaining high level of economic growth. The responsibility of formulation and implementation of monetary policy in Ethiopia is vested in the National Bank of Ethiopia (NBE). Macroeconomic stability fosters employment and economic growth. Maintaining exchange rate stability on the other hand is considered as the principal policy objective of NBE so as to be competitive in the international trade and to use exchange rate

[86] Eyader Teshome, *Legal and regulatory issues of the Ethiopian foreign exchange regime and transactions*, p 68
[87] Article 20(5) of proc 591/2008

intervention as policy tools for monetary policy to affect both foreign reserve position and domestic money supply. [88]

2.5 The parallel market under the Establishment proclamation no 591/2008

Article 20 of Proclamation No.591/2008 is a basic legal provision in relation to Regulation of Foreign Exchange in Ethiopia. It is the basic provision for categorizing a foreign exchange market as legal or illegal (parallel). Article 13 of the establishment proclamation defines "transaction in foreign exchange" as the transfer, borrowing, lending, assignment, exchange, purchase, sale, receipt, payment or crediting of foreign exchange; and b) the conclusion of any contract, agreement, arrangement or understanding, as a result of which any foreign exchange is transferred, borrowed, lent, assigned, exchanged, purchased, sold, received, paid or credited within or outside Ethiopia;

In a large majority of developing countries, transactions in foreign exchange are subject to restrictions and only a small group of intermediary is permitted to engage in currency transactions.[89] Likewise, Article 20(1) of the establishment proclamation mandates only authorized banks/dealers to engage in foreign exchange transaction. The other sub provisions of the same article restate the power and mandate of the NBE to regulate by directives, most aspects of foreign exchange transactions.

To implement this provision of the proclamation, the NBE has been issuing various directives stating the ways how the transactions in authorized institutions takes place and the responsibilities of the foreign exchange transactor like to transact only with authorized dealer, surrender, to fulfill the repatriation and the declaration requirement. [90]

Article 20(1) clearly states, "*No person shall engage in any transaction of foreign exchange except with banks or authorized dealers or with the special permission of the National Bank*." Accordingly, every transaction in foreign exchange as defined under Article 2(13) must be

[88] Mengesha Manedo: *The impact of monetary policy on output and price in Ethiopia*, MA thesis, Addis Ababa University, June 2016 , p 16 [Herein after ; Mengesha Manedo: the impact of monetary policy on output and price in Ethiopia]

[89]Pierre- Richard Agenor, *Parallel currency markets in developing countries: Theory, Evidence and policy implications* ,Essay*s* in international finance No 188, November 1992, p 2 [Herein after; *Pierre- Richard Agenor, Parallel currency markets in developing countries*]

[90] Eyader Teshome, *Legal and regulatory issues of the Ethiopian foreign exchange regime and transactions*, p73

carried out through banks or authorized dealers or with the special permission of the National Bank. The legal consequence of breaching Article 20(1) entails criminal penalty in addition to confiscation of property.[91] With regard to regulation of foreign exchange transactions, Article 21(5) entrusts NBE with power to:

a) Appoint insurance companies, other financial institutions and authorized dealers to engage in transactions involving foreign exchange, gold or silver;
b) Issue directives relating to transactions in foreign exchange, gold or silver;
c) Delegate banks and other financial institutions to issue foreign exchange permits.

As far as the implementation of Article 21(5(a)) is concerned, NBE so far authorized only commercial banks to engage in business of foreign exchange transactions even before enactment of this Proclamation.[92] This implies that parallel foreign exchange market which is being transacted by individuals without authorization from the National bank is illegal since the NBE doesn't authorize them.

The classification of the formal foreign exchange market and the illegal parallel market starts here. The Official market is a forex market traded by authorized (licensed) commercial banks in compliance with the official foreign exchange rules and regulations set by the monetary authority.[93] On the other hand, parallel or black market is a forex market where private individual and/or institutions either operate without official licensing to do business in foreign exchange or those who are licensed to operate as part of legal trading institutions but who at the same time involved in the illegal parallel market without compliance with rules and regulations.[94] As a result, Article 26 of the establishment proclamation stipulates penalty for violating Article 20 of the proclamation by referring the provisions of the criminal code of Ethiopia.

> 26(1) whosoever: a) In violation of the provisions of this Proclamation or regulations or directives issued pursuant to this Proclamation: (1) engages in transactions of foreign exchange or fails to

[91] See Proclamation 591/2008, Article 26 & The Criminal Code, Article 346 & 785
[92] Proclamation No 591/2008 and Interview with Ato Tibebu H/Ghiorgis, Vice-Director of Foreign Exchange Monitoring and Reserve Management Directorate of NBE, April 15/ 2018

[93] Tefera Lemma, *Determinants of Parallel Foreign Exchange Market in Ethiopia*, p.6
[94] *Ibid*

declare to a bank or authorized dealer when he acquires foreign exchange or the right to receive foreign exchange;

(2) Receives or effects payments in foreign exchange; shall without prejudice to the confiscation of the property with which the offence is committed, be punishable in accordance with the provisions of the Criminal Code.

Article 346 and 785 are the relevant criminal code provisions which read as follows.

Article 346 - Illicit Traffic in Gold, Currencies or Foreign Exchange.
Whoever, apart from cases coming under the provisions relating to crimes against currency (Title V below), buys, imports or exports, accepts in trust, deposits, exchanges, sells or offers for sale without authorization or contrary to laws, regulations or rules, gold or any currency, whether national or foreign, the dealings with or rates of which are subject to limitation, restriction or measures of control or protection, is punishable with rigorous imprisonment not exceeding ten years, and fine not exceeding fifty thousand Birr, without prejudice to the confiscation of the subject matter of the crime.

Article 785 - Violations of Provisions Dealing with Illicit Traffic in Gold, or Currencies
Whoever apart from the cases specified in Article 346 of the Criminal Code, violates laws, regulations or directives, issued concerning gold or currency, whether national or foreign, the dealings or rates of which are subject to limitation, restriction or measures of control or protection, is punishable with fine not exceeding three hundred Birr or arrest not exceeding three months.

Moreover, Article 26(2) put the minimum punishment which is applicable unless the higher penalty is applicable in the criminal code of Ethiopia which reads as follows.

26(2) unless a higher penalty is applicable under the Criminal Code pursuant to sub-article (1) of this Article: a) the punishment shall, without prejudice to the confiscation of the property with which the offence is committed, be rigorous imprisonment not exceeding 15 years and fine not less than Birr 50,000 and not exceeding Birr 100,000 where the accused misused the power of his official position or where he committed the offence with intent to improperly amass wealth or where the offence is committed repeatedly;
b) where the offence is connected with currency, gold, security, goods or any other property, the fine shall, without prejudice to the confiscation of the property with which the offence is committed and the punishment of imprisonment, not exceed three times the value of the property unless it is lower than that imposed under paragraph (a) of this sub-article;

c) where the offence is committed by a body corporate, the fine may, without prejudice to the confiscation of the property with which the offence is committed, be raised to six times the value of gold, currency, security, goods or any other property with which the offence is committed unless it is lower than that imposed under paragraph (a) of this sub-article.

Despite all these punishments however, the parallel foreign exchange market is being transacted actively in many places in Addis Ababa even openly.

2.6 Foreign exchange control in Ethiopia

Article 20 (2) authorizes the NBE to determined by directive "*...the conditions, limitations and circumstances under which residents of Ethiopia, and nonresidents visiting Ethiopia, or any other person may possess and utilize foreign currency or instruments of payments in foreign exchange…*". Here under, the researcher discusses those restrictions that make the parallel market an important alternative means of foreign exchange transaction in Ethiopia.

2.6.1 Foreign exchange for selected persons

Like many other countries in the world, parallel foreign exchange market in Ethiopia existed because of the foreign exchange control in the country. The inability of the formal market to fulfill the needs of foreign exchange mainly because of shortage of foreign currency in the country results in foreign exchange control.[95]

Basically, the controls are imposed to try and protect government's limited stock of foreign currency reserves. The need for this protection is in turn stimulated by trade deficits and/or capital flight which result in net demand for foreign exchange at the central bank. It logically follows that once the government imposes restrictions and limitations on the holding of foreign exchange or on transferring it overseas, demand for alternative sources for that currency emerge. Thus, government's inability to meet the demand for foreign currency and its interference in the operation of the market has a propensity to fuel the creation of parallel market for foreign exchange.[96] The same holds true in Ethiopia. The NBE issued different directives that strictly control the foreign exchange market as a response to the shortage of foreign currency.

Any resident in Ethiopia can't ask foreign currency from formal market as of right. Those who are entitled to buy foreign currency from banks are importers, business and government travelers abroad, Ethiopian student overseas or patients to be treated in a foreign country. [97] As a result,

[95]Conditions in Ghana are broadly similar to those in most other Sub-Saharan African (SSA) countries. The colonial economy, prior to 1983, maintained a controlled fixed exchange rate regime characterized by surrender laws, foreign exchange rationing and currency inconvertibility. Under this regime, exporters were required by law to surrender all their foreign exchange earnings to the Bank of Ghana at the fixed official rate, and the purchase of foreign exchange for capital transaction was illegal. As imports were quantitatively restricted, and foreign exchange rationed, smuggling activities thrived leading to the emergence of black market for foreign exchange as a source of its finance. As a result of the higher rates farmers received for their foreign exchange in the black market, about 20 percent of the cocoa harvested was smuggled out (May, 1985), further reducing the government revenue. see

[96]Albert Makochekanwa*, Zimbabwe's Black Market for Foreign Exchange,* p 2

[97]Directive No. FXD/17/2001; Directive to amend the operation of Foreign Exchange Bureaux, Directive No. FXD/09/1998, , National Bank of Ethiopia, 30 March 2001[Hein after; FXD/17/2001]

any resident can't access foreign exchange in commercial banks that engage in foreign exchange transactions because they are prohibited by NBE. Shortage of foreign currency and restrictive nature of the regulation might lead to such prohibition. [98]

So the Ethiopian foreign exchange law doesn't unconditionally entitle all Ethiopians to get foreign currency from authorized dealers. To get access to foreign exchange in Ethiopia, a person should either engage in import or export trade by holding relevant license or has reasonable justification as well as evidence such as business and holiday travel to abroad, overseas education, medical issues and etc. Foreign exchange is also allowed for purchase of publications, periodicals, journals, books, membership fee, advertisement, examination fee, registration fee, admission fee, etc.[99]

2.6.2 The conditions and the Maximum amount allowed

The NBE has come up with a directive (Directive No.FXD/17/2001),setting the legal conditions, requirements and maximum foreign exchange amounts permitted for various purposes. Directive No.17/2001 has been amended by Directive No.FXD/33/2007 and Directive No.FXD/39/2009, the two currently repealed by Directive No.FXD/42/2013 only to modify the maximum amounts.[100] NBE regulates through these directives the conditions and the maximum amount of foreign exchange that Authorized Commercial Banks are supposed to avail for a holiday travel, Business Travel Allowance, Medical Expenses, Educational Expenses, Seminar, Workshop, Symposium, Conference and Training Fees and Other Expenses.[101] The maximum amount legally allowed has been increasing since the 1977 regulation due to inflation and/or reduction of purchasing power of currency.[102]

Under Directive No.FXD/33/2007 and Directive No.FXD/39/2009 the payment limit for holiday travel allowance, business and government travel allowances, medical travel expense and educational expenses was 1000 (USD One Thousand) and 3000 (USD Three Thousand) respectively. [103] Currently the cash note payment limit is amended to be USD 4000 (USD Four

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[98] Eyader Teshome, *Legal and regulatory issues of the Ethiopian foreign exchange regime and transactions*, p 81
[99] FXD/17/2001,Article 10
[100] Directives on operation of Foreign Exchange Bureaux, Directive No.FXD/33/2007, Directive No.FXD/39/2009, and Directive No. FXD/42/2013 amended Directive No. FXD/17/2001 on Operation of Foreign Exchange Bureaux
[101] .FXD/17/2001, Article 4-9
[102] see Foreign Exchange Control Regulation, National Bank of Ethiopia, Legal Notice No.01/1977, Article 42, Article 43, Article 45[Herein after; Regulation No.01/1977]

Thousand) for holiday travel allowance, medical treatment expense and educational expenses and USD 10,000 (USD Ten Thousand) for business and government travel allowances under Directive No.FXD/42/2013. [104] It should be noted that the stated amount is the maximum limit one is entitled to get, and does not necessarily mean one always get USD 10,000 in all business travel allowances.[105]

In case of medical treatment expense and educational expenses, the payment is effected through transfer to the medical/educational institution abroad or by draft.[106] Payment of foreign exchange for purchase of publications, periodicals, journals, books, membership fee, advertisement, examination fee, or registration fee is also made to institutions abroad through commercial banks.[107] Before enactment of this directive, the payment was used to be made directly to the individual concerned to whom the later undertake to produce receipt for amounts spend and to refund any unexploited amount. However, this requirement was proved to be useless since it is amenable to malpractice. [108]

The detail conditions and requirements for availing foreign exchange to the above individuals are set forth under Directive No.FXD/17/2001. For instance, presentation of passport, valid exit visa and air ticket are the preconditions for availing foreign exchange for a holiday travel outside Ethiopia to Ethiopian national or a foreign resident.[109] On the other hand, Presentation of valid licenses or letters of support from the pertinent bodies together with passport, valid exit visa and air ticket are pre-requisite for a bona-fide business travel to representatives of business organization, welfare institutions, religious associations, organizers of trade exhibitions, tourism, cultural show and sports.[110]

Here it should be noted that, you can't request the bank beyond the maximum amount stated in the directive. But you may demand more than the stated maximum amount for your affair, for instance medical purpose. In this time the only option the people have is to use an alternative option obviously parallel foreign exchange market. The other point that is worthy to mention here is, the above stated maximum amount is given to the applicant, if and only if the bank has

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[103] FXD/33/2007, Article 3(a) &.FXD/39/2009
[104] FXD/42/2013, Article 3
[105] Eyader Teshome, the *legal and regulatory issues of Ethiopian foreign exchange regime and transactions*, p 82
[106].FXD/42/2013, Article 3.1(c) & (d)
[107] FXD/17/2001, Article 10
[108] Eyader Teshome, *the legal and regulatory issues of Ethiopian foreign exchange regime and transactions,* p 82
[109] FXD/17/2001, Article 4
[110] FXD/17/2001, Article 5

foreign currency. If the bank is in shortage of foreign currency, the bank avail a little amount of foreign currency after long delay or you may be said good bye with nothing. Now again the option is parallel foreign exchange market. The above discussed directives will be applied and the stated maximum amount of foreign currency will be availed, if and only if the foreign currency is available in the bank. Moreover the priority as well as large percentage of foreign exchange is given for payments of imports rather than other matters.[111]

Since there is serious shortage of foreign currency in the country, the NBE also issued Transparency in Foreign Currency Allocation and Foreign Exchange Management Directive No.45/2016 and Directives No.FXD/46/2017 particularly to introduce two measures: Prioritization of foreign exchange for certain import items and payments and to adopt a "First-come-First-Served" procedure.

2.6. 3 Priority for certain import items and "First-come-First-Served" procedure

Directive No.FXD45/2016[112] and Directives No.FXD/46/2017[113] introduces two measures: (1) Prioritization of foreign exchange for certain import items and payments and (2) "First-come-First-Served" procedure. The purpose of the proclamation is to ensure efficient and proper allocation of foreign exchange which is a scarce resource; to ensure transparent and sound allocation of foreign exchange based on priority without opening a room for rent seeking behavior and malpractice.[114] As a result, the directive require each bank to have transparent and sound foreign currency allocation and foreign exchange management guideline or procedure manual which shows the accountability of employee of a bank involved in the foreign exchange transaction.[115]

"*Transparent and sound allocation of foreign exchange to priority and other economic sectors without opening a room for rent seeking behavior and malpractice*" is one of the rationale behind for adoption of such measures as declared under preamble of the Directive. It begins with recognition of the fact that "foreign exchange is a scarce resource that should be managed

[111] Interview anonymous commercial bank manager, April 4,2018

[112] Directive on Transparency in Foreign Currency Allocation and Foreign Exchange Management ", National Bank of Ethiopia, Directives No.FXD/45/2016 [Herein after; FXD/45/2016]

[113] ''Directive No 46/2017" Amendment to directive No 45/2016 Transparency in Foreign Currency Allocation and Foreign Exchange Management, National Bank of Ethiopia, Directives No.FXD/46/2017,[Herein after; FXD/46/2017]

[114] The preamble of FXD 45/2016

[115] The preamble of FXD 45/2016

carefully to ensure its efficient and proper allocation."[116] The scarce nature of foreign currency leads some sectors, goods and payment to get priority in the interest of public. If there is scarcity, there is excess demand as a result to manage the scarcity, prioritization of some sector is necessary.[117]

The reported discriminatory allocation of foreign exchange by banks in favor of their clients demanded First-come-First-Served" procedure. [118]Before enactment of this directive, banks used to allocate foreign exchange based on their own policy and priority to their clients.[119] As a result, the need to ensure fairness require banks to avail foreign exchange to any customer regardless of whether he/she maintain accounts in that bank or not. Adoption of "First-come-First-Served" procedure guaranties equal access to foreign exchange.[120]

Article 6 of Directive No.45/2016 listed import items based on their priority on first come first served procedure. These are:

A. imports of essential goods, i.e., fuel, fertilizer and other agricultural inputs, pharmaceutical product, factories' requests for procurement of machineries, equipments, spare parts, raw materials and accessories; import of nutritious food for babies.
B. payments on imports of freight and transit services;
C. payments authorized by the National Bank of Ethiopia such as foreign loan, suppliers credits, interest , profit, dividend and excess sales of foreign airlines; and
D. Salary transfer of foreign employees.

A closer investigation of those lists reveals that their words and phrases were drafted in general and ambiguous terms and such broad meaning open a room for different interpretation and loopholes. Due to this reason those priority lists are modified in a way that provide detail lists under the new Directives No.FXD/46/2017.[121] Furthermore, those priority lists are amenable to revision by NBE.[122] Consequently, Article 6.1 of Directive No.FXD/46/2017 amended the above provision and stated that in the allocation of foreign currency, a bank shall give priority to the listed import items and payments, among them, on first come first served basis.[123]

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[116] *Ibid*
[117] Eyader Teshome, *Legal and regulatory issues of Ethiopian foreign exchange regime and transactions*, p 97
[118] *Id p 98*
[119] Interview with anonymous Commercial Bank manager, April 4/2018
[120] Eyader Teshome, *legal and regulatory issues of Ethiopian foreign exchange regime and transactions, p* 98
[121] Id p 99
[122] FXD/46/2017, Article 6.32
[123] FXD 46/2017 Article 6.1

6.1.1 Imports of essential goods, i.e.

(1) Fuel, motor oil, lubricants and LGP gas (2) fertilizer
(3)agricultural inputs and machineries [seeds and pesticides, irrigation pumps, animal feeds, machineries and equipments, tractors, harvesting machineries and their spare parts, animal hybrids; (4) pharmaceutical product [medicine laboratory equipments and reagents , medical equipments and appliances;]. (5)Manufacturing industries requests for procurement of machineries, equipments, spare parts, raw materials and accessories; (6) Import of nutritious food for babies; (7 Spare part for construction machineries for own use construction companies whose total values not exceeding USD 50,000;(8) Educational materials[Exercise book, ball pen, pencil and Printing papers,] (9) Import of chemicals; 10)Profit and dividend transfer (11)Transfer of excess sales of foreign airlines; (12) Sales from share and liquidation of companies by FDI.

The NBE may also amend the above lists as required.[124]

The above provision implies that, those lists have precedence over other claim of foreign currency. In other words, banks sale foreign currency to other clients after it allocates to those lists. In a large majority of developing countries, purchase of foreign currency is restricted by the authorities reserving for essential goods such as imports of capital goods.[125] The researcher believes that such exclusion of others from accessing foreign currency is the fuel that exacerbates the need for parallel market.

The directive does not set a time limit within which those lists under Article 6.1 have priority over other request of foreign exchange. The actual phrasing of the provision seems to give absolute priority.[126] The shift towards the parallel market by legal importers should therefore be explained by the rationing-out of `non-priority importers' from the official foreign exchange reserves.[127]

Moreover, for one import application, importers cannot request foreign currency on more than one bank.[128] Because lodging same foreign currency request at more than one bank creates additional demand resulting artificial scarcity.[129] Any importer who fails to comply with such

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[124] FXD 46/2017 Article 6.3 ,

[125] Pierre- Richard Agenor , *Parallel currency markets in developing countries*: p 2

[126] Eyader Teshome ,*Legal and regulatory issues of the Ethiopian foreign exchange regime and transactions*, p 99

[127] Tesfamariam Mehari ; *Modeling monetary and Fiscal policy in Ethiopia: A macroeconomic approach* ; PHD thesis, Liverpool,John Moores University, May 1998, p 41[Herein after; *Tesfamariam Mehari ;Modeling monetary and Fiscal policy in Ethiopia*]

[128] FXD 46/2017, Article 11(1)

[129] Eyader Teshome, *Legal and regulatory issues of the Ethiopian foreign exchange regime and transactions*, p 102

restriction will be black listed from six month up to two years.[130]The NBE ascertains whether importer apply to more than one banks from the lists sent to it by each banks. [131]

2.6.4 Foreign currency allocation based on personal connection

The other problem in allocating foreign exchange is allocating foreign currency based on the personal connection rather than strictly adhering to the above discussed directives. Such act is becoming the trait of the foreign exchange regime. Banks, be it private or public, are allocating foreign currency based on personal connection than economic merit of engagements. While those with the right connection can access it, regardless of the economic worth of their importing engagement, those having no connection, but could have benefited from transactions with the higher return to the economy, cannot have it. It seems that the whole forex regime of the nation is falling victim to patronage and opportunism. While larger firms, state-owned enterprises, and enterprises owned by the ruling party do not typically face major problems in obtaining foreign exchange, less well connected importers, particularly smaller, new-to-market firms face delays in arranging trade-related payments.[132]Such mal practice is found almost in every institution in Ethiopia and it is hardly possible to say banks are free from such acts.[133] This mal practice also can be one reason for shifting to the parallel market.

2.7 The Nature of the Parallel foreign exchange Market in Ethiopia

The net result of all the above restrictive policies in the formal market is the creation of the parallel market as an alternative means of accessing foreign exchange.[134] Parallel markets for foreign exchange can emerge only when the government imposes exchange controls, that is,

[130] FXD 46/2017, Article 11(2)

[131] Eyader Teshome, *Legal and regulatory issues of the Ethiopian foreign exchange regime and transaction* , p102

[132] Addis fortune: Ethiopia, 'Patronage Become Threat to Forex Allocation' ,online The *Ethiopia Observatory (TEO,* https://ethiopiaobservatory.com/2015/04/24/addis-fortune-editorial-patronage-become-threat-to-forex-allocation-whose-interests-decide-on-forex/#more-33607(last accessed May 3/2018)

[133] Interview with Ato Eyob Abreham, Manager of Awash international bank, Merkato branch , March 29/2018

[134]Conditions in Ghana are broadly similar to those in most other Sub-Saharan African (SSA) countries. The colonial economy, prior to 1983, maintained a controlled fixed exchange rate regime characterized by surrender laws, foreign exchange rationing and currency inconvertibility. Under this regime, exporters were required by law to surrender all their foreign exchange earnings to the Bank of Ghana at the fixed official rate, and the purchase of foreign exchange for capital transaction was illegal. As imports were quantitatively restricted, and foreign exchange rationed, smuggling activities thrived leading to the emergence of black market for foreign exchange as a source of its finance. As a result of the higher rates farmers received for their foreign exchange in the black market, about 20 percent of the cocoa harvested was smuggled out (May, 1985), further reducing the government revenue. See Aliyu Rafindi, Sanusi, 'Lessons from the foreign exchange market reforms in Ghana, 1983-2006', *Journal of Economics and Allied Fields, 2010, Vol. IV No. 2, ,*pp 1-19, at p 2, [Herein after, Aliyu Rafindi, Sanusi, Lessons from the foreign exchange market reforms in Ghana, 1983-2006]

restrictions on the volume of certain foreign exchange transactions or the amount of foreign exchange that can be bought or sold for particular transactions or/ and on the price at which such transactions are made affecting the demand or supply of foreign currencies and causing excess demand or supply to spill over into a parallel market. Trade barriers, quantitative restrictions, or high tariffs alone are not in themselves sufficient to give rise to a parallel exchange.[135] Parallel markets are likely to be unimportant, and the parallel premium is low, when payments restrictions and capital controls are either minimal or not enforced.[136]

Parallel market may be legal or illegal. When the parallel market for foreign exchange is legal, it is often referred to as a dual exchange rate (DER) system.[137] A number of countries have experimented with DER systems of varying duration.[138]

Illegal parallel market systems emerge when private agents attempt to evade restrictions on the price or quantity of foreign exchange transactions. Illegal parallel markets were the norm in most of Africa and South Asia, as well as in several Latin American countries, especially through the 1980s. The authorities, with some exceptions, generally tolerated the parallel markets.[139]

In principle, there is little difference, in terms of macroeconomic implications, between legal and illegal systems. In either legal or illegal systems, there are incentives for transactions to spill over or "leak" from one market into the other. These leakages may tend to undermine the dual exchange rate systems, depending upon how rigidly exchange controls are enforced.[140]

The size of these markets depends upon the range of transactions subject to control as well as the degrees to which restrictions are enforced. In countries like Ethiopia where large and chronic balance of payments deficits force the central bank to ration foreign exchange allocated to the private sector because government needs are large and must be satisfied in priority , parallel

[135] Nita Ghei and Steven B.kamin , *the use of the parallel market rate as a guide to setting the official exchange rate,* p 500

[136] *Id* p 501

[137] *Ibid*

[138] Some countries maintained official dual exchange rates for long time periods, such as Belgium (from 1957 to 1990) and the Dominican Republic (until 1993). France (1971–74) and Italy (1973–74) adopted dual rates for a short period following the collapse of the Bretton Woods system as a transitory measure. Argentina, Mexico, and Venezuela adopted DER regimes in the 1980s in the wake of balance of-payments crises and huge capital outflows. see Nita Ghei and Steven B.kamin , *the use of the parallel market rate as a guide to setting the official exchange rate*, p 500

[139] Nita Ghei and Steven B.kamin , *the use of the parallel market rate as a guide to setting the official exchange rate*, p 500

[140] *Ibid*

currency markets will typically be developed with an exchange rate substantially more depreciated than the official rate.[141]

These restrictions creates an excess demand in the foreign exchange market that leads to a situation in which hard currencies are being traded at a premium above the officially accepted exchange rates. [142]In plain language, if the people could not find what they want from government shops or by legal means, they are prepared to pay extra to get it through the parallel-market. In order to fulfill their demand which is not fulfilled by the NBE, majority of the people seek foreign exchange through parallel market.

Though considered illegal and criminally punishable, the business of selling and buying foreign exchange is being conducted openly at various places in Addis Ababa. Participants in the parallel market are not defined, especially as the operators are not accorded legal recognition. As a result of this, anyone who needs to either sell or buy forex may become an operator in this market. There are corridors where large amount of money exchange takes place in broad daylight in Addis Ababa's streets[143].Some places are particularly identified as forex shops which are around Merkato *(*American Gibe and T/Himanot area), Kazanches in front of Hilton Hotel, Piyassa, around main Post office, behind Ethiopia Hotel, around Gandhi Hospital, in front of national bank of Ethiopia, Bole and in different shops in the city. It is really difficult to know their exact number. The main reason is the shops in the above areas are working foreign exchange hiding in other shops like shoe shops, souvenir shops and in similar shops. This is recognized when they take someone to a certain shop to exchange the foreign currency. They have also a hidden room in almost all the shops in the above area but the front door is for other legal works. Particularly the narrow street from Meskel Square to Ambassador Cinema is perhaps among the few places

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[141]Perre Richard Agenor and Nadeem U.Haqu, *Macroeconomic management with informal financial market* , Washington Dc 20431 , USA, p 90 [Herein after, *Richard Agenor and Nadeem U.Haqu, Macroeconomic management with informal financial market]*

[142] Nita Ghei and Steven B.kamin , *the use of the parallel market rate as a guide to setting the official exchange rate* p, 500

[143]Desta Gebrehiwot: *The Ethiopian herald*, 'Informal channels raise red flag on forex earning', Online, http://www.ethpress. gov.et/herald/index. php/news/national-news/item/9551-informal-channels-raise-red-flag-on-forex-earning (last accessed March 19, 2008)

in the city. [144] Most of the small shops along this street double as exchange bureaus. This becomes evident when a couple of youngsters stop passersby a number of times to ask if there is currency exchange needs. Some could even appear to be overzealous in their attempt to find customers as they quote daily USD/Birr exchange rates or even start negotiation as they chase potential customers up the street.[145] Dollar has been exchanged openly around Gandhi hospital and Biherawi and it had never been considered as a crime in the last four decades.[146]

In the informal market, they will be able to maximize their revenue by evading taxes and exchanging their foreign currency earnings in the parallel market where the rate is higher than the official exchange rate offered by the banks.[147]

Based on the previous assessment of NBE which was made in 2004, the market (probably a single shop) can avail hundred thousands of US dollar at a time in a single transaction.[148] Now a single shop exchanges 200,000 USD per day.[149]This shows that the market is still important and can finance even big forex demand.[150] It is possible to estimate that the volume of transaction is in billions of foreign currency considering the unknown number of parallel market dealers in the city.

The other feature of parallel market dealers is that all parallel market dealers don't stand on the streets to chase passengers in different places of the city. The transaction is done merely with a telephone communication. If a person abroad wants to send money for his family or his use, He/ she may not be required to go to bank. He/she just contact an Ethiopian owned shop and hand over a dollar or other foreign currency and then the service provider contacts an agent in Ethiopia to arrange payment in local currency to the remitter's family or other beneficiary. Within a few hours or minutes, the remitter's family or other beneficiary will receive a text message telling that the money is ready to collect. Without either side of transaction having a bank account, this is an efficient way of transferring cash and such arrangement is known as '*Hawala'* which is the

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[144] https://www.thereporterethiopia.com/article/precarious-birr (last accessed April 27/2018)

[145] The researcher's observation from April 20-22

[146]Addisu Taddese, 'Black Market or open air market money changers' online, Magazine http://ethiofact.com/3461/black-market-or-open-air-market-money-changers/

[147] Tesfamariam Mehari ; *Modeling monetary and Fiscal policy in Ethiopia*: p 41

[148] Teferra Lemma*, determinants of parallel foreign exchange market in Ethiopia* ,p 11

[149] Interview with anonymous parallel market dealer working in Merkato , April 15/ 2018

[150] Teferra Lemma, *determinants of parallel foreign exchange market in Ethiopia,* p 11

other name of foreign exchange transaction through parallel market. The foreign currency collected in the foreign shops from millions of Diasporas will be deposited thee for Ethiopian importers who used to open a letter of credit (LC) under invoicing or who can't access the required foreign currency in the formal market. The importer will receive the foreign currency collected when he goes there to import items.

There is a strong network between these dealers and importers. In the transaction described above, money is transferred between two parties living in two different countries but cash does not cross borders. The money also never enters the conventional banking system. The transaction is based upon a single communication between the two dealers and is usually not recorded or guaranteed by written contract between them. A bond of trust that exists between the two dealers secures the debt. Country 'B' dealer has no legal means to seek redress in the event of a default by the Country 'A' dealer on payment of the debt.[151] The collected foreign currency finally delivered to the Ethiopian importers. This transaction is the most detrimental to the Ethiopian economy and is in fact difficult to control and monitor it since the transaction is done by mere telephone communication. The researcher will discuss this transaction in a detail manner in other part of the paper.

2.8 Source of Supply and demand of Parallel foreign exchange market in Ethiopia

There are different sources of supply and demand for the parallel market in different countries depending on the nature and effectiveness of exchange restrictions imposed.[152] Generally however, the supply of foreign currency in the parallel foreign exchange market has five principal sources: smuggling of exports, under invoicing of exports, over invoicing of imports, foreign tourists and the diversion of remittances from abroad into unofficial channels. Besides, government officials may also divert foreign currency from official to the parallel market through corruption. [153]

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[151] Leonides Buencamino and Sergei Gorbunov, *Informal Money Transfer Systems: Opportunities and Challenges for Development Finance*, November 2002 T/ESA/2002/DP/26, DESA Discussion Paper No. 26, United Nations, p2 [Herein after; Leonides Buencamino and Sergei Gorbunov, *Informal Money Transfer Systems*]

[152] Perre Richard Agenor and Nadeem U.Haqu, *Macroeconomic management with informal financial market* , p 91

[153] Derrese Degefe, *The parallel foreign exchange market and macroeconomic performance in Ethiopia* , p 17

In Ethiopia, the dominant sources of supply of foreign exchange for the parallel market are largely contraband exports (smuggled exports) of goods and services and unofficial private transfers. On the other hand, legal and illegal imports, and residents travel abroad are generally the principal sources of demand for foreign exchange. Contraband importers who want to escape import taxes are the other source of demand for the parallel market. Invisible payments such as payments for medical, education and travel services abroad are the dominant sources of demand for foreign exchange in the parallel foreign exchange market of Ethiopia.[154]

Here under, the researcher discusses the main supply and demand of the parallel market in current Ethiopia.

2.8.1. Ethiopian importers

In Africa, importers who lacked access to ever scarce foreign exchange through the official channels turned to the parallel market to obtain foreign exchange for trade transactions.[155] In Ethiopia also, an important group of buyers of foreign currency from parallel market are importers whose efforts to obtain foreign currency was not successful for different reasons particularly because of the inability of the central bank to provide the foreign currency for so many restrictions discussed above.[156]

The demand of legal importers for foreign currency in the parallel market arises because of foreign exchange rationing in the official market. [157]The trend of under-invoicing import items is becoming common. Under-invoicing is the practice of declaring a lower than actual price on an invoice for import items. The difference is then paid to the seller in cash. The only way to fill the shortage is by accessing hard currency from the parallel market.[158] For the sake of importing the items legally, importers open letter of credit by requesting some amount of foreign currency less than what he/she needs.

However, now the NBE enacts a new directive, directive number 52/2017 and its amendment 53/2018 to avoid under invoicing. The researcher will discuss the directive in a separate section of the paper. Ono importer opined that there is no hard currency in bank so the only option the importers have

154 Derrese Degefe, *The parallel foreign exchange market and macroeconomic performance in Ethiopia* , p 17

155 Nita Ghei and Steven B.kamin , *the use of the parallel market rate as a guide to setting the official exchange rate* p 503

156 Tesfamariam Mehari ; *Modelling monetary and Fiscal policy in Ethiopia*, p 46

157 Perre Richard Agenor and Nadeem U.Haqu, *Macroeconomic management with informal financial market* , p 91

158 Interview with the anonymous importer in Merkato, April 3/2018

is buying hard currency from the parallel market. The importers have to wait more than a year to get less than what they request. But in the parallel market, hard currency is accessible at any time with a better rate.[159] The preference is to use banks but if it is not accessible, the choice of the importers is using parallel market.[160]

There are two ways of managing the foreign currency sourced from parallel market for importation purpose. The first choice is travelling to the country he/she imports carrying the foreign currency. This one is somewhat risky but the importers do it.

The other one is the importer collect foreign currency through his agent abroad. His agent receives foreign currency from Ethiopians abroad who used to send money for their family or personal affair. Then the importer will deliver the money in Ethiopian birr with attractive rate for the remitter families or for the purpose send. Then the importer takes the foreign currency collected abroad and uses it for importation.[161]. Most importers prefer this method as the risk is low.[162] It is worthy to mention that, it is expensive to buy dollar or other foreign currency from parallel market than the official one. Currently the importer should buy 1USD by 35 Ethiopian birr in the parallel market. But the Bank sells it around 26 birr. There is almost 8 birr difference which is not negligible. This shows that the motive of the importers in diverting to the parallel market is the inaccessibility of the required foreign currency and long delay in the formal channel. This is the main reason for choosing the parallel market.

2.8.2 Remittance from Abroad (unofficial private transfer)

Informal remittances are defined as remittances that do not pass through officially regulated businesses at both the send and receive ends of a transaction. Informal methods include: hand carrying foreign currency, giving foreign currency to someone travelling to Ethiopia, using an

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159 Interview with Ato Eyob Abreham, Manager of Awash international bank, Merkato branch, March 29/2018

160 Interview with Ato Zeynu Mohammed, importers of different products in Merkato, April 5

161 Interview with anonymous parallel market dealer working in Merkato, April 14

162 see A.S.M. Sharif Mahmud , Determinants behind the use of informal channels for remitting money from overseas by the wage earners of Bangladesh ,Master’s thesis May 2012, p 28, [Herein after, A.S.M. Sharif Mahmud , Determinants behind the use of informal channels for remitting money from overseas],In Bangladesh Informal remittance is also resulted by the influence of Importers. Big importers maintain hawala channels to collect foreign currency. They often under invoice the commodity price to reduce import duty. The rest part of the payments is made directly in foreign currency with the exporter. So, as the importers need to hold foreign currency which is beyond the existing foreign exchange regulation, so they employ agents overseas to collect foreign currency. The agents thus provide lucrative offer to the wage earners. This ultimately reduces remittance through formal channels.

unregulated money transfer operator (often known as *hawala*).[163] These are the main sources of foreign currency for parallel market.[164] The final destination of such sourced currency is parallel market for foreign exchange.

For any developing country, remittance can be a critical tool, contributing significantly to a country's entire economic health. In part, remittances can build foreign currency reserves, address balance of payments deficits, and enable investment projects involving infrastructure, health, sanitation, and education. Ethiopia benefits tremendously from the support of its Diaspora, particularly from its rural population who has migrated in search of temporary employment in the Middle East. Often equivalent to at least 50 percent of the recipient's monthly income, remittances improve quality of life, enhance health and nutrition, and fund investment in local economies.[165]

The volume of remittances that flow into a country depends on several factors, including the size of migrant population, facilities for transferring funds and level of economic activity in the migrant-recipient countries.[166]

Migrant remittances account for over 5 per cent of the Gross Domestic Product (GDP) of Ethiopia and one quarter of the country's foreign exchange earnings. The value of incoming remittances exceeded the country's export earnings in the first ten months of 2016.At the household level; remittances also represent a vital source of income for many individual recipients. The size and scale of remittances also creates the possibility for harnessing these flows for productive investment, thus contributing to the long-term development of Ethiopia.

While the Government has made great strides in recent years to increase the flow of formal remittances, evidence suggests that informal networks remain a prominent way for Ethiopians to send money home. 78 per cent of total remittances may currently pass through informal channels in some corridors. Lack of access to services in the send and receive markets, high direct and indirect costs associated with formal channels, irregular migration, the existence of parallel

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[163] Leon Isaacs**:** *The Executive Summary of a Research Study to Enhance the Volume and Value of Formal Remittances to Ethiopia***,** August 2017 p 13{herein after *Leon Isaacs***:** *The Executive Summary of a Research Study]*

[164] Interview anonymous parallel market dealers working around Stadium , April 8/2018

[165]Tom Keatinge, *Growing an Economy, Impact of Foreign Exchange and Remittances on Ethiopian Development*, policy brief September 2014, p1[Herein after, *Tom Keatinge, Growing an Economy*]

[166] Alemayehu Geda and Jacqueline Irving, *Remittances Markets in Africa*, 2011,p 11

market exchange rates, and regulatory barriers for undocumented migrants contribute to the high level of informal transfers. [167]

Informal flows not only represent a loss of foreign exchange for the Government of Ethiopia, but also prevent the Government from tracking Anti-Money Laundering and Financing of Terrorism (AML/CFT).[168]

Ethiopia's current Deputy Prime Minister, Demeke Mekonnen also confirms that 78 percent of the money sent home by the Ethiopian Diaspora is going through informal channels.[169] The IOM said remittance inflow from Ethiopians living in the USA, England and Italy is below expectations. [170] The Middle East and South Africa are two notable places where huge numbers of undocumented migrants [171]are believed to be facing challenges of sending money formally. Out of the 1.2 million migrants in the Middle East and 200,000 in South Africa, 90 percent are likely to be remitting informally to Ethiopia. By the estimates of Ministry of foreign affairs (MOFA), from Saudi Arabia alone, where some 750,000 Ethiopians are believed to be living, USD 590 million is estimated to be remitted. A USD 158 million remittance could be sent from migrants in South Africa as well. While the Government has made great strides in recent years to increase the usage of formal remittances, informal networks remain prominent ways for Ethiopians abroad to send money back home. [172]

Moreover some countries do not allow undocumented people to send money formally even if they wish to. In fact, there are also documented migrants, who are able to use formal channels but who for a variety of reasons choose not to do so. Gulf States and South Africa for instance do not allow illegal migrants to send money formally. [173]

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[167] Leon Isaacs**:** *The Executive Summary of a Research Study* ,p 6

[168] *Ibid*

[169] http://apanews.net/en/pays/ethiopie/news/ethiopia-sees-increasing-remittances-informal-money-transfers-persist-offical last accessed (May 6/3018) He confirms it when speaking during the launching of a report by the International Organization on Migration (IOM). The International Organization for Migration is an intergovernmental organization that provides services and advice concerning migration to governments and migrants, including internally displaced persons, refugees, and migrant workers.

[170]Birhanu Fekede, 'Ethiopian Diaspora remits USD 4 bln' online, the reporter, https://www.thereportere thiopia.com/ content/ethiopian-diaspora-remits-usd-4-bln. 26 August 2017 9 [last accessed April 27)

[171] The most relevant global example of this solution has been used by Mexican nationals in the United States where the Mexican Government has issued a document called the *matricula consular*. In turn, financial institutions in the United States accept the *matricula consular* as a valid form of identification for the purpose of conducting a range of financial services. However, this recommendation does acknowledge the inherent challenges with introducing such a scheme. Such an initiative may have a greater chance of success if it is undertaken on a multilateral as well as a bilateral level.

[172] Leon Leon Isaacs**:** *The Executive Summary of a Research Study* ,p15

[173] *Ibid*

According to many observers, efficient international consumer-oriented payment mechanisms capable of handling a very large number of small transactions do not exist in the formal economy. This lack of outreach by the formal sector coupled with traditions of not utilizing formal financial systems has resulted in a growing population of unbanked individuals. Developed countries money transfer process is either costly or inefficient or is undertaken outside of the conventional financial system.[174]

Annual private transfer from Ethiopians abroad through formal channel

Annual transfer	**(In Thousands of Birr)**
Particulars	**Private Transfers**
1996/97	1,677,357.7
1997/98	2,186,483.8
1998/99	2,167,833.2
1999/00	3,081,301.3
2000/01	3,707,733.4
2001/02	3,806,431.5
2002/03	4,839,056.9
2003/04	6,648,604.2
2004/05	8,848,942.2
2005/06	10,646,610.5
2006/07	13,786,728.4
2007/08	22,149,512.8
2008/09	28,077,689.4
2009/10	34,976,069.4
2010/11	44,720,538.8
2011/12	56,048,138.9
2012/13	65,041,069.1
2013/14	78,737,597.5
2014/15	98,079,743.1
2015/16	135,551,945.0
2016/17	123,113,898.0

Source: National bank of Ethiopia

[174] Leonides Buencamino and Sergei Gorbunov, *Informal Money Transfer Systems*, p 12

Estimating informal flows into Ethiopia is extremely difficult. However, drawing on a variety of data sources, high-level estimations can be made regarding the size of the informal market. Household surveys, combined with migrant stock and flow data, can be very helpful in building a true reflection of the total remittances markets, including both the formal and informal volumes.[175]

A World Bank national survey found that an average of 14 per cent of adults or 5.4 million people were on average receiving USD 120 a year, totaling an estimated USD 3.2 billion.12 Remittances received by the NBE were recorded as USD 1.8 billion in the same year. This would imply a shortfall of around USD 1.4 billion, which is roughly approximate to the World Bank's estimate that 50 per cent of remittances flow through informal methods globally.[176]

The other estimation is on the potential remittance flows that are being captured by the informal market by corridor. It uses approximate estimations of the number of migrants (irregular and regular) in both the Kingdom of Saudi Arabia and South Africa, and combines this with estimations of the level of remittances individuals would be sending back using the data of returnees from the Kingdom of Saudi Arabia as a proxy (namely 73 per cent sending USD 1,080 per year).[177] It then compares this to the World Bank Bilateral Matrix estimates to try and understand how much is currently flowing through the formal system compared to how much is likely being sent in total.[178] Using this method, the total remittance flows from the Kingdom of Saudi Arabia could be as much as USD 394 million annually. (This uses the conservative estimate of 500,000 Ethiopians living in the Kingdom of Saudi Arabia.) [179]However, the World Bank only records USD 148 million, around 50 per cent of the total flows, which is similar to other estimates above. If the Ethiopian Ministry of Foreign Affairs (MOFA) estimates are taken (namely, that there are 750,000 Ethiopians living in the Kingdom of Saudi Arabia), the total remittance flows would be estimated to be closer to USD 590 million. This is almost four times

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[175] Leon Issacs, *The Executive Summary of a Research Study* ,p 13

[176] 'Outlook for Remittance Flows 2010-2011'. Migration and Development Brief, World Bank. (2010). as cited by Leon Issacs, The Executive Summary of a Research Study , p 13

[177] Assessment of the socio-economic situation and needs of Ethiopian returnees from KSA., IOM, (2014). as cited by Leon Issacs, The Executive Summary of a Research Study , p 14

[178] World Bank. (2015). *Bilateral Remittance Estimates for 2015 using Migrant Stocks, Host Country Incomes, and Origin Country Incomes (millions of US$)* (October 2016 Version) as cited by Leon Issacs, The Executive Summary of a Research Study , p 14

[179]*Ibid*

the figure estimated in the World Bank Bilateral Matrix. This data clearly shows significant shortfall in remittances sent through formal channels. Similarly, when taking 65,000 as a conservative estimate of the number of Ethiopians living in South Africa, remittance flows could be as high as USD 51 million. However, the World Bank's Bilateral Matrix data suggests they are closer to USD 15 million – over three times less than what may be sent.[180]

If the upper estimate given by MOFA is used (200,000 Ethiopians living in South Africa), the potential annual remittances sent could be as high as USD 158 million. This is over ten times the amount the World Bank suggests flows through this corridor. Although any method to quantify informal remittances will be an estimate, the significant amount of foreign exchange being lost by the Government can still be highlighted.[181]

This evidence call the creation of policies focused on scaling the volume of formal remittances by addressing the problems surrounding it. For example, out of the USD 748.98 million estimated to have been sent from Saudi Arabia and South Africa, 78 per cent was sent informally.[182]

The informal money transfer system or '*hawala'* are working like banks having agent here and abroad. They control huge remittances from abroad distorting the country's economy.[183] The government is unable to allocate foreign exchange gained from the remittance. In order to avoid such network and to channel the foreign currency from remittance to the formal channel, the NBE recently enacts a new directive (fxd no 52/2017 and 53/2018) which requires LC to be equal with the invoice document.[184] The researcher will discuss the directives in another chapter of the paper in a detail manner.

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180 Leon Issacs, The Executive Summary of a Research Study , p 14
181 *Ibid*
182 *Ibid*
183 Interview with Ato Betre Mekonnen ,Customer service officer in Commercial bank of Ethiopia, Mehetema ghandi branch ,May 26/2018
184 Interview with Ato Abebayehu rufira, officer in the external sector research department in NBE, April 12/2018 and May 25/2018

2.8. 3. Ethiopians and Non Ethiopians Coming from Abroad

Many foreigners used to visit Ethiopia as the country is enriched with much attraction for tourist. Ethiopians abroad also used to come here to visit their families and/or for several reasons. These Ethiopians and non Ethiopians coming from broad come here carrying huge hard currency. Another example of the adverse impact of foreign exchange controls on the Ethiopian economy is the extent to which immigrant workers entering Ethiopia from countries are believed to bring foreign currency with them in excess of NBE regulations. Their expenditures drive up the price of goods and services.[185]

Most of them convert their foreign currency in to Ethiopian birr using the parallel market through brokers who get commission for making foreign currency accessible to the parallel market. This is mostly done by guiders who are assigned to help foreigners. Moreover, the attractive rate in the black market over the official one makes all sellers of foreign currency to stick on the parallel market.[186]

Ethiopians who were abroad also exchange their foreign currency in the parallel markets at a better rate by avoiding transfer fees. It also happens that they send hard currencies via travelers they trust so that they give it to their relatives who in turn get it converted in local parallel markets. The World Bank estimated that 14% of Ethiopians to whom money was transferred from abroad in 2010 got it through travelers. It means the total amount of hard currencies entering Ethiopia by informal channels is much higher than the 14% who regularly receive remittances.[187]

Parallel market dealers also witness this fact saying that there are many people who come to Ethiopia carrying huge foreign currency and come to the parallel market for exchange. They also said that, there are foreign currencies which can't be converted in bank. Kuwait (Kuwait's

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[185] Tom Keating, *Growing an Economy* , p 3

[186] Interview with anonymous parallel market dealers working around Merkato , April 15,2018

[187] J. Bonsa, Ethiopia: 'Rush for the Exits: Why Is Ethiopia's Capital Flight Accelerating?' online, – Addis standard http://addisstandard.com/rush-for-the-exits-why-is-ethiopias-capital-flight-accelerating/ (last accessed April 28/2018)

money) Oman (Oman's money) and other currencies are being converted in the parallel market only as the bank is not buying them.[188]

2.8.4. Education fee, medical payments, travelers' costs and other invisible payments

For medical payments, education fee, travel costs and for other purposes, people divert to the parallel market. The long delay and scarcity of foreign currency in the official market divert almost all the demand of foreign currency to the parallel market.[189]The maximum limit allowed for medical expenses, holiday, travel allowance, medical payment and educational expenses is amended to be USD 4000 (USD Four Thousand).[190] Obviously the maximum amount granted by the banks may not be sufficient for the above purposes. Moreover, the accessibility of the maximum amount is not promising taking the foreign currency scarcity in to account. In these scenarios, buying foreign currency from the parallel market is not a matter of choice.

2.8.5. Contraband traders

The main buyers of foreign currency from parallel market are contraband traders. Contraband traders who used to buy goods from different border areas need foreign currency in huge amount to buy different items. They also buy foreign currency to exchange it in border area since there is one birr increment from the parallel market rate in capital.[191] These illegal importers provide cheap and reliable source of imports for residents. This activity tends to be tolerated by the authorities.[192] Illegal trade creates a demand for illegal currency which in turn stimulates its supply and leads to the expansion of a parallel currency market if the central bank is unable or unwilling to meet all the demands for foreign exchange at the official rate.[193]

2.8.6 Illegal Exporters

These are the other providers of foreign currency for the parallel market. Legal and illegal livestock markets are operating at different magnitudes in the Amhara Region's Ethio-Sudan cross-border. Small farmer exporters and traders are the major actors in the illegal cattle marketing system while medium- to large scale licensed exporters are dominantly operating in

[188] Interview with Anonymous parallel market dealers working in Merkato and American gibi, April 13/2018
[189] *Ibid*
[190] .FXD/42/2013, Article 3
[191] Interview with anonymous parallel market dealer around Merkato ,April 15/2018
[192] Tesfamariam Mehari ; *Modelling monetary and Fiscal policy in Ethiopia:*, p 41
[193] Pierre- Richard Agenor, *Parallel currency markets in developing countries*, p 6

the legal system. Most cattle sales are related to farm households' cash needs and commercial orientation.[194] There are five illegal but important cattle export routes in the Amhara Region's Ethio- Sudan border.[195] The Ethio-Sudanese cross-border livestock trade uses three legal currencies: US dollar, Ethiopian birr and Sudanese dinar.[196] The use of the Sudanese dinar is rare. Legal exporters sell cattle in USD and exchange the hard currency to Ethiopian birr at the Ethiopian banks.[197]

The legal system contributes about 40% of the total export volume and the remaining (60%) is the contribution of illegal system in 2007. The total export volume in the Amhara Region's Ethio-Sudan cross-border trade is estimated at 100 thousand cattle in 2007. If the illegal cattle export could be shifted to the legal system, the total value of export earnings in 2007 is estimated to be USD 30 million in the North Gondar Zone alone.[198] With no doubt, the proceeds from such illegal cattle export are destined to the parallel market. There are many cattle sellers around the border in USD and they don't want to convert it in the bank of course for a better rate.[199]

2.8.7 Hoarding foreign currency as a wealth Accumulation

Nowadays people are accumulating foreign currency particularly USD in their home like gold believing that the value of USD increase from time to time. It is not uncommon to see people who hoard foreign currency in their home after buying from the parallel market. The last year 15% devaluation of Ethiopian birr more encourage such practice. When the value of dollar

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[194]Elias Mulugeta, Berhanu Gebremedhin, D Hoekstra and M Jabbar*: Analysis of the Ethio-Sudan cross-border cattle trade: The case of Amhara Regional State*, International Livestock Research Institute (ILRI), 2007, p 1 [Herein after; Elias Mulugeta, Berhanu Gebremedhin, *D Hoekstra and M Jabbar: Analysis of the Ethio-Sudan cross-border cattle trade*]

[195]Id p 16, The export points of these illegal routes are the Sudanese small towns of Berekete The export points of these illegal routes are the Sudanese small towns of Berekete Nur, Tiha, Galabat, and the Ethiopian towns of Abrehajira and Abdurafi. Two of the illegal export points, Tiha and Berekete Nur, are also around MetemaYohannes. Berekete Nur is the most important illegal export outlet, and is located north of Metema Yohannes. The Berekete Nur and Tiha routes mainly work for Metema and Quara *woredas*, but farmers from as far as Tach Armachiho and Western Armachiho *woredas* also use these illegal routes. See Elias Mulugeta, Berhanu Gebremedhin, *D Hoekstra and M Jabbar: Analysis of the Ethio-Sudan cross-border cattle trade*:

[196] *Id* p 27

[197] *Ibid*

[198] Elias Mulugeta, Berhanu Gebremedhin*,* D Hoekstra and M Jabbar: *Analysis of the Ethio-Sudan cross-border cattle trade* , p 20

[199] Interview with Ato Dereje Getahun, Manager of foreign exchange department in Awash international bank head office , April 18/2018

becomes so high again, they sell it. [200]But those who fear risk of hoarding foreign currency in home save it in the bank using one of the relative's foreign currency account.[201]

CHAPTER THREE

Effects of excluding the parallel market from foreign exchange regulation

Currently as it is discussed in Chapter two, the parallel foreign exchange market is not being regulated by the country's foreign exchange regulation. There are various negative consequences of excluding the parallel market from the foreign exchange regulation.

3.1 Losing transparent capital flow in the country

Parallel market is an illegal act and criminally punishable in the Ethiopian legal system.[202] Despite this fact however, the market is exploring more than ever.[203] Since the market is illegal, there is no any obligation on the parallel market dealers. They are not required to report the volume of transactions, the manner of the market and other related issues. As the researcher tried to show in chapter two of the paper, a single shop exchanges 200,000 dollars in a single day.[204] It is not difficult to imagine the sum of foreign currency being transacted in the numerous parallel forex dealers in the capital of Ethiopia. This obviously shows the government can't report the real foreign currency available in the country and it is impossible to make an effective monetary policy by disregarding the billions dollars in the parallel market. The researcher wholeheartedly

[200] Interview with anonymous parallel market dealers around merkato ,April 13/2018
[201] Interview with Ato Eyob Abreham, Manager of Awash international bank, Merkato branch, March 29
[202] Article 785 and 347 of Ethiopian criminal code
[203] Muluken yewondessen, 'Despite devaluation black market dollar rate gap highest ever' online , *Capital news,* http://capitalethiopia.com/2018/02/26/ despite-devaluation-black-market-dollar-rate-gap-highest-ever/ (last accessed on May 2/2018)

[204] Interview with anonymous parallel market dealer working around stadium , April 18/2018

believes that, the government already lost control on the foreign currency. Importers, Exporters, traders Ethiopian abroad and almost all the demands of foreign currency turned its face to the parallel market. Ethiopia's foreign currency supply available for importers and travelers alike is increasingly facing chronic shortages. As the country's foreign exchange provision plummets into a whirlpool, the parallel or black market for hard foreign currency (which has become a rare commodity), is thriving in the country. [205]

The expansion of the parallel market for foreign exchange leads to the loss of government control over the economy as more and more of the official transactions are diverted to the parallel market.[206]

The report of the National bank of Ethiopia regarding the country's foreign currency shows only the foreign currency transaction in the official market that mean banks forex transaction not the country's foreign currency. Official balance of payments statistics will not show the true position of the country and such misleading statistics will also mislead policy makers.[207]

Policy makers are being misleaded by taking the report of NBE as an input in their policy making. Distorted data result distorted policy. The billions dollars and may be more are not reported to the NBE and NBE doesn't know them as there is no any mechanism placed to control their volume of transaction. As a result, the laws and policies on the monetary policies are not effective. The collection and analysis by governments of quality economic, demographic, and social data are often keys to development. Without reliable, regular, and consistent data collection, it is very difficult for a government to judge the effectiveness of its policies or determine its next actions.[208]

3.2 Shortage of foreign currency in the formal channel and its impact on the economy

Due to the poor foreign currency mobilization, developing countries like Ethiopia are characterized by the existence of a long lasting foreign exchange gap which is a factor for their

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[205] Tesfa News ; 'Ethiopia's foreign exchange crisis' online, *Tesfa News* :https://www.tesfanews.net/ethiopias-foreign-currency-crisis/ posted January/2016 (last accessed May 1/2018)

[206] Deresse Degefa, *the parallel foreign exchange market and macro economic performance in Ethiopia*, p 6
[207] Asmerom Kidane*, Exchange rate policy and Economic reform in Ethiopia,* p 8
[208] Tom Kiantige, *Growing an Economy*, p4

chronic balance of payment[209] crises, deterioration of terms of trade[210], foreign currency shortage and huge debts.[211] The availability of adequate foreign currency reserves[212] is a major determinant for developing countries' economy due to the dependence of their domestic economy on external factors, in which both domestic production and consumption are highly dependent on import of goods and services from the international market and the existence of ineffective demand and supply.[213] The informal market premium has a negative effect on the balance of payments because it induces exporters, migrant workers and agents with capital accumulated abroad to abandon the banking system in favor of informal channels. Although this shift improves the balance of informal current and capital accounts; it deteriorates the officially recorded balance of payments (BP).[214] The level of foreign exchange reserves depends on the net inflow of foreign exchange. It depends on exports of goods and services, remittances from citizens living abroad, aid, public borrowing from abroad and direct investment of foreigners in the domestic economy.[215]

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[209] Balance of payment is a statistical record which shows all the economic transactions which occurs between residents of a country and the rest of the world. It shows the extent of a country's technical development and hence competitiveness in the world market. See Mikias Merhatsidk, Foreign currency crunch: 'Why is it happening every now and then ?' online, *Ethiopian business review:* http://ethiopianbusinessreview.net/index.php/economy-finance/item/155-foreign-currency-crunch-why-is-it-happening-every-now-and-then?

[210]The national bank's data highlight the distressingly widening trade imbalance which continues to haunt Ethiopia's balance of trade. As such, the trade deficit was put at an estimated -6.27 billion dollars in 2009/10, -10.47 billion dollars in 2013/14 and roughly -6.6 billion dollars for only the first two quarters of 2015. This imbalance has partly been caused as a result of slow-evolving export growth rates with falling commodity prices and lack of diversification in exports, loopholes underscored by the International Monetary Fund's (IMF) report. Visit http://ethiopianbusinessreview.net/index.php/economy-finance/item/155-foreign-currency-crunch-why-is-it-happening-every-now-and-then?

[211] Mikias Merhatsidk, Foreign currency crunch: 'Why is it happening every now and then ?' online, *Ethiopian business review:* http://ethiopianbusinessreview.net/index.php/economy-finance/item/155-foreign-currency-crunch-why-is-it-happening-every-now-and-then? (last accessed May 7/2018)

[212]A reserve currency, also called an anchor currency, is a currency that is held in significant quantities by numerous governments and central banks as part of their foreign exchange reserves. These currencies are pricing currency for global trade-particularly to commodities such as gold, oil and coffee. Foreign-exchange reserves: foreign currency deposits and bonds held by central banks, commonly includes foreign exchange, gold, and others. These are assets central banks use to back their liabilities such as the issuance of local currencies and various reserves deposited with the central bank. The amount of foreign exchange reserves that a country has is used as an indicator of the ability to repay foreign debts. Visit http://ethiopianbusinessreview.net/index.php/economy-finance/item/155-foreign-currency-crunch-why-is-it-happening-every-now-and-then?

[213] Kenedy Abebe :Ethiopia: Foreign Exchange Crunch Now, Then, Tomorrow ,online, *Addis fortune*, September 2017 https://addisfortune.net/columns/foreign-exchange-crunch-now-then-tomorrow/ (last accessed April 17/ 2018)

[214] Tesfamariam Mehari ; *Modeling monetary and Fiscal policy in Ethiopia,* p 46

[215] *Id* p, 124

The NBE is working to improve the export sector by different incentives in order to decrease the foreign currency shortage problem.[216]

Currently, Ethiopia is experiencing economic growth, and to continue along this successful path and reach middle-income status by 2025, the government is implementing a number of development plans. According to the Growth and Transformation Plan (GTP), about 60% of expenditure of projects will be paid in hard currencies.[217] Those developmental goals are hardly possible to achieve without the availability of foreign currency. Accordingly to achieve the admirable goals set out in GTP[218], that requires a significant amount of foreign currency, the government is expected to develop and implement a strategy that promotes and improves foreign currency mobilization.[219] To continue along this successful path, reach middle-income status, and achieve the admirable goals established in the GTP, it must reconsider its foreign exchange controls. This regime has eroded the country's international economic competitiveness. Without improving private sector's access to borrowing capacity and foreign exchange that would create a more favorable business environment, growth will be restricted. The maintenance of strict foreign exchange controls appears to be exacerbating Ethiopia's current account deficit position as a result of which imports continuing to outstrip exports as a result.[220]

The severe foreign currency shortage that the country is facing now is retarding investment and business activities and also slowing down the overall economic activity of the country. The crunch in foreign exchange provision has reached a painful level.[221] The foreign currency reserve is lower than it should be. Foreign exchange from export doesn't finance the import of fuel and

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[216]Interview with Ato Tibebu H/Ghiorgis, Vice-Director of Foreign Exchange Monitoring and Reserve Management Directorate of NBE, April 15/ 2018

[217] Mikias Merhatsidk, Foreign currency crunch: 'Why is it happening every now and then?' online, *Ethiopian business review:* http://ethiopianbusinessreview.net/index.php/economy-finance/item/155-foreign-currency-crunch-why-is-it-happening-every-now-and-then? (last accessed May 7/2018)

[218] The Growth and Transformation Plan (GTP) is a national five-year plan created by the Ethiopian Government to improve the country's economy.

[219] Mikias Merhatsidk, Foreign currency crunch: 'Why is it happening every now and then?' online, *Ethiopian business review:* http://ethiopianbusinessreview.net/index.php/economy-finance/item/155-foreign-currency-crunch-why-is-it-happening-every-now-and-then? (last accessed May 7/2018)

[220] Tom Kiantige, *Growing an Economy*, p 5

[221] Tesfa News ; 'Ethiopia's foreign exchange crisis' online, *Tesfa News* :https://www.tesfanews.net/ethiopias-foreign-currency-crisis/ posted January/2016,(last accessed May 1/2018)

the manufacturing industry and importers routinely struggles to gain foreign currency permits for the import of raw materials and capital goods.[222]

The controlled foreign exchange regime is abating the flow of funds through channels outside the periphery of the Ethiopian authority and thus challenging the successful implementation of GTP.[223] Lack of available foreign reserves is compounded by the government's rigorous control of foreign exchange movement into and out of the country. The government is pursuing a policy that artificially inflates the value of the birr and hinders investment, economic growth, and development.[224]

These problems are negatively affecting employment and production, there by slowing down the overall performance of the country's economy. As foreign currency shortage has been a chronic problem in Ethiopia for over half of a century, it continues to exacerbate the long lasting balance of payments, crisis, trade deficit and indebtedness.[225]

Many factors have contributed for the existence of long lasting foreign currency shortage in the country. The first in fact the root cause for the problem is Export being heavily dominated by few primarily agricultural products. Moreover insignificance of the volume of our export relative to that of competitors is the other cause. The heavy dependence of domestic production and consumption on the import of raw materials, capital and consumer goods has exacerbated the foreign currency shortage as earnings from export can't finance the required foreign currency for imports. Obviously there is a need to diversify exports and specialize in the production and export commodities so that the country gains a comparative and competitive advantage over competitors.[226]

The other factor for severe shortage of foreign currency in the country is the existence of the informal parallel markets within the economy in which a significant proportion of the country's income is channeled and circulated.[227] The informal sector accounts for a reported half of all foreign currency inflow and outflow. Remittances are a significant contributor to the Ethiopian

[222] Kenedy Abebe :Ethiopia: Foreign Exchange Crunch Now, Then, Tomorrow ,online, *Addis fortune*, September 2017 https://addisfortune.net/columns/foreign-exchange-crunch-now-then-tomorrow/ (last accessed April 17/ 2018)
[223] *Ibid*
[224] Tom Keatinge, *Growing an Economy*: p 2
[225] Kenedy Abebe :Ethiopia: Foreign Exchange Crunch Now, Then, Tomorrow ,online, *Addis fortune*, September 2017 https://addisfortune.net/columns/foreign-exchange-crunch-now-then-tomorrow/ (last accessed April 17/ 2018)
[226] *Ibid*
[227] Interview with Ato Abebeyehu rufira, the officer in the external sector research department in NBE, April 12/2018

economy and can help accelerate the country's development. IMF data suggest that remittances and official transfers represent more than 4 percent of Ethiopian gross domestic product, with estimates of remittance values ranging from $387 million to $3 billion. This range partly reflects the difficulty in measuring these flows due to the significant use of informal remittance channels as a result of an underdeveloped banking industry and, likely, the tight foreign exchange control regime that the country imposes. [228]

Ethiopians have sent home as much as 3.5 billion US Dollar in 2014 /2015; approximately 7.4 % of the country's GDP according to the report from International organization for migration. However, 78% of which is sent to Ethiopia through informal channel in some corridors.[229] The informal sector accounts for a reported half of all foreign currency inflow and outflow.[230]

Since a significant amount of remittance is channeled through the informal market, it is severely under exploited.[231] The remittance passing through the informal channel is drying the foreign currency reserve of the country. It is affecting the country's economy. Its impact on the economy is incomparable with the impact the local parallel market may have.[232]

As a result, Ethiopia continues to experience widening current account deficits and a fluctuating foreign exchange reserves. The demand for foreign currency to finance import bills of various goods has been growing from year to year, partly due to public and private investment boom: capital goods, intermediate inputs, and consumer goods. However, the supply side for foreign currency is constrained by poor export sector performance and erratic foreign aid inflow. This gap between the demand for and supply of foreign currency keep on widening through time resulting in depletion or else fluctuation in the reserve position. Nevertheless, one of the major contributing factors towards realizing the economic growth as set out in the Growth and Transformation Plan is adequate foreign currency holding of the country. This is because availability of foreign currency capacitates the economy to meet the demand for investment

[228] Tom Keatinge, *Growing an Economy*:, p 3
[229] Leon Issacs , *The Executive Summary of a Research Study* ,p 6
[230] Kenedy Abebe :Ethiopia: Foreign Exchange Crunch Now, Then, Tomorrow ,online, *Addis fortune*, September 2017 https://addisfortune.net/columns/foreign-exchange-crunch-now-then-tomorrow/ (last accessed April 17/ 2018)
[231] *Ibid*

[232] Interview with Ato Abebayehu Rufira, officer in the external sector research department in NBE, April 12/2018

hence economic growth in the long run and enables the Monetary Authority to create stable macroeconomic performance in the short run, in broad sense.[233]

Nowadays lack of foreign currency has become the day and night news. Of course banks have no sufficient foreign currency. Ethiopia has been hit by foreign currency crises for the last three years and the shortage has gotten worse in the last one year. The preeminent challenge arises from emerging informal trends in the forex regime. These trends, which include a flourishing parallel market, rationing of foreign exchange through personal connections and underground forex market conducted through commission agents, most of whom double as bank officials, are posing a huge challenge to the monetary sphere. It seems that these trends are hijacking the formal forex market that evaluates currency allocation based on the returns an engagement brings to the overall economy. As they are left unattended by the regulators, the trends are calling for chaos in the currency market.[234]

The banks have nothing to give for importers. The importer must wait more than a year not to give them what they request but at least some of it.[235] It is s just like small drops that banks give to those who need it most. There are even some banks that have stopped giving hard currencies for travelers.[236] The forex shortage is so critical that opening a Letter of Credit (LC) takes as long as one year or even more, and even then, there is no guarantee that the requested amount of foreign currency will be availed.[237] Unlike the past couple of years when there has always been an issue with Forex, business owners are now confronted with the prospect of shutting down their factories. The better option is to locate the source of forex for their imports of raw materials from wherever it is available, and whatever is the going price. The shortage has now reached unbearable proportions. Not even the pharmaceutical importers, the last frontier to be

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[233] Interview with Ato Abebayehu Rufira, officer in the external sector research department in NBE, April 12/2018

[234] Kenedy Abebe :'Ethiopia: Foreign Exchange Crunch Now, Then, Tomorrow' ,online, *Addis fortune*, September 2017 https://addisfortune.net/columns/foreign-exchange-crunch-now-then-tomorrow/ (last accessed April 17/ 2018)

[235] Interview with Ato Dereje Getahun, the Manger of foreign exchange department in Awash international bank head office ,held in April 18/2018

[236] Dawit Endeshaw,' parallel-forex-market-raises concern': online, *Addis fortune*, *Vol* 17 *,No* 867, Dec,2016] https://addisfortune .net/columns/rise-in-parallel-forex-market-raises-concern/ (last accessed 3/17/2018)

[237] Tesfa News ; 'Ethiopia's foreign exchange crisis' online, *Tesfa News* :https://www.tesfanews.net/ethiopias-foreign-currency-crisis/ posted January/2016, (last accessed May 1/2018)

deprived of access to forex, can get approval from their respective banks to open letters of credit.[238]

The domestic companies are unable to operate their factories; some of them have already begun to have layoffs of their labor, including an elevator assembly company and a soap and detergent factory. Almost every commercial bank is suffering from its inability to mobilize as much domestic savings as it should. Thus, a credit crunch is on the horizon.

Some of private commercial banks have already stopped receiving applications for loans; and they are discriminatory on the basis of whether the applicant brings foreign exchange through exports.

The national bank's data highlight the distressingly widening trade imbalance which continues to haunt Ethiopia's balance of trade. As such, the trade deficit was put at an estimated -6.27 billion dollars in 2009/10, -10.47 billion dollars in 2013/14 and roughly -6.6 billion dollars for only the first two quarters of 2015. This imbalance has partly been caused as a result of slow-evolving export growth rates with falling commodity prices and lack of diversification in exports.

Importation is almost halted in the country because of foreign currency scarcity.[239] Loss of income taxes and domestic indirect taxes and a reduced flow of foreign exchange to the central bank lower the government's capacity to import.[240] The existence of a parallel market facilities the switch from domestic currency assets to foreign currency assets and may reduce the revenue accruing to the government.[241]

A declining export, acute shortage of hard currency, an insatiable demand for imports, widening trade deficit and a crushing foreign debt is heading Ethiopia's economy to a crisis.[242] Dr Mulatu Teshome, confirmed the severe shortage of foreign currency and its impact on the country's economy. He said that the country is broken faced with a serious shortage of hard currency and

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[238]Tesfa News ; 'Ethiopia's foreign exchange crisis' online, *Tesfa News* :https://www.tesfanews.net/ethiopias-foreign-currency-crisis/ posted January/2016, (last accessed May 1/2018)

[239] Interview with Ato Eyob Abreham , Manager of Awash international bank, Merkato branch ,March 29/2018

[240] Pierre- Richard Agenor , *Parallel currency markets in developing countries*, p 12

[241] *Ibid*

[242] Tesfa News ; 'Ethiopia's foreign exchange crisis' online, *Tesfa News* :https://www.tesfanews.net/ethiopias-foreign-currency-crisis/ posted January/2016, (last accessed April 26/2018)

export trade has dwindled in last three years. Major projects like the construction of railway and universities will not be carried in 2018 budget year due to a serious shortage of finances. The president said more taxes will be levied on the big taxpayers to boost the amount the government obtains from taxes.[243]

However if we see the issue in deep, there is foreign currency shortage in the bank but not in the parallel market. Here the researcher wants to note that, Ethiopia is a least developed country and there is no sufficient amount of hard currency as there is less export and high importation. However though this natural shortage is obvious, the shortage is getting worse and able to stop importers from importation in the formal way because the real mobilization of foreign currency is controlled by the parallel market. There is a huge supply and demand in the parallel market. The parallel market dealer anonymously said that "the supply and demand is always available and I don't remember the day that we stop working because of demand and supply shortage".[244] Informal trade does not suffer from the chronic shortage of the medium of exchange commonly seen in formal trade, such difficulties being avoided by means of the parallel exchange market for all relevant currencies which is operated by numerous well-known dealers.[245]

The Ethiopian economy is constrained by capital. The two other factors of production, labor and land, are found in abundance in the economy. Thus, the total factor productivity of the economy, which measures the level of efficiency that an economic input is turned into output, is largely determined by the level of capital at the disposal of the economic agents, be it the state or an enterprise. In this sense, therefore, capital and all its threads, be it local or foreign, will have huge impacts on growth.[246] To achieve economic growth, the government of Ethiopia should allow broader access to foreign exchange to bring a larger portion of the country's substantial remittance flows into the regulated financial sector.[247]

3.3 Capital flight

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[243] Tesfa News ; 'Ethiopia's foreign exchange crisis' online, *Tesfa News* :https://www.tesfanews.net/ethiopias-foreign-currency-crisis/ posted January/2016, (last accessed April 26/2018)

[244] Interview with anonymous parallel market dealers working around stadium, April 17/2018

[245] Tesfamariam Mehari ; *Modelling monetary and Fiscal policy in Ethiopia:* ; p 41

[246] Inttervew with Zemzem Mohammed, an economist working in the economic sector research department. April 7 /2018

[247] Tom Kiantige, *Growing an Economy*, p6

There exists no generally accepted definition of the term “capital flight”. For the purpose of this paper, capital flight refers to illicit financial flows, which disappear from any record in the country of origin. Moreover earnings on the stock of illegal capital flight outside of a country generally do not return to the country of origin. [248]

In Ethiopia, the role of the parallel market is simply to collect and bulk hard currencies. Where exactly the collected money goes is anybody’s guess. As discussed above, importers who face constraints in foreign exchange rationing may smuggle out the hard currency they collected or/and importers may assign agents in foreign countries to collect and bulk hard currencies from them. In both cases, importers may spend the money they bulked on purchasing goods and services that will eventually enters Ethiopia though it passes illegally. This is an optimistic scenario since the country may eventually benefit from availability of goods and services in the domestic market though the transaction is done informally and the government might have lost some tax revenues.[249]

The worst part is the hard currencies collected from local parallel market may get smuggled out and get deposited in foreign bank accounts. Similarly, parallel markets operators residing abroad may also primarily motivated to safely deposit the hard currencies they collected from Ethiopians Diaspora in a foreign bank account. Illegal currency exchange corners in the capital are contributing to increasing illicit financial outflows and business people are always on the demand side.[250] This will be capital flight which is the uncertain and rapid movement of large sums of money out of a country. The government has no mechanism for tracking and monitoring the capital fleeing from the country through parallel market. [251]The illegal outflow of foreign currency has gone up recently. Since the recent drop of the birr (Ethiopian currency) by 15% against the US dollar, the illegal flight of US dollar and the number of people attempting to

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[248] Dawit Taddese, ‘fighting capital flight in Ethiopia’, *Journal of Business and Administrative Studies (JBAS),* Fighting capital flight in Ethiopia, vol. 5, no., 2013, pp. 47-63.p 47

[249]J. Bonsa, Ethiopia: ‘Rush for the Exits: Why Is Ethiopia's Capital Flight Accelerating?’ online, – Addis standard http://addisstandard.com/rush-for-the-exits-why-is-ethiopias-capital-flight-accelerating/ (last accessed April 3/2018)

[250] Tesfa Mogessie : ‘Ethiopia Feeling the Pinch of Illicit Financial Outflows’online, *Tesfa News*: https://www.tesfanews.net/ethiopia-feeling-illicit-financial-outflows-pinch/ (last accessed May 1/2018)

[251] *Ibid*

smuggle US dollar out of the country have increased dramatically.[252] Unrecorded remittances also contribute substantially to estimated capital flight in some countries. In Ethiopia, the volume of remittances reported by the World Bank in 2010 was about half of the amount reported by the Central Bank ($661 million).[253] Some experts believe that the transfer of money through unregulated channels will also likely result in illicit financial flow and dealings. The seizure of 541,659 USD around Harar is a recent indication of informal corridors of hard currency.[254] The Ethiopian government cannot control the capital flight in the country.[255]There should be a mechanism that the government can see the flow of the capital in and out of the country.[256]

3.4 Loss of tax Revenue

As the researcher tries to discuss above, the major demand of hard currency from parallel market arise from illegal traders. Those traders used to go to the border area carrying the huge foreign currency and pass the items he/she buys illegally obviously to avoid taxes. The anonymous parallel dealer said that these traders pass their products free from taxes and they sell their products here in less price and he continued by saying that most similar product suppliers are becoming out of the business game. The parallel market dealer said that these traders have no difficulty in smuggling these products and those people who are assigned to prohibit such activities around the border are not doing properly. "There are many customers who buy USD from the parallel market and they never caught by the responsible person."[257] Loss of tariff revenue as a result of smuggling and under invoicing is the normal consequence of parallel market in developing countries.[258] The government is losing huge tax revenue because of the accessibility of parallel market. The existence of parallel market creates a suitable environment for illicit market activities like contraband trade.

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[252] Shiberu Tamerat,' Capital Flight Reaching Alarming Level' online, *Tesfa News*, https://www.tesfa news.net/ Ethiopia -capital-flight-reaching-alarming-level/ published November 3/2017 ,(last accessed May 2/2018)

[253] https://oromianeconomist.com/2014/08/18/ethiopias-capital-flight-is-estimated-at-us24-9-billion-or-83-8-of-the-gdp/ ; last accessed May 3/2018

[255] Interview with Ato Dereje Getahun, Manager of foreign exchange department in Awash international bank head office, April 18 /2018

[256] Desta G/hiwot , 'Informal channels raise red flag on forex earning', online, *The Ethiopian Herald;* http://allafrica.com/stories/201709140729.html (last accessed April 23/2018)

[257] Interview with anonymous parallel market dealer working around Merkato April 13,/2018

[258] Pierre- Richard Agenor , *Parallel currency markets in developing countries*: p 12

3.5 Open door for money laundering and terrorism financing risks

Money laundering is legitimization (washing) of illegally obtained money to hide its true nature or source.[259]Informal flows through parallel market not only result loss of foreign exchange for the government of Ethiopia, but also prevent the government from tracking Money Laundering and Financing of Terrorism (AML/CFT).[260]

Informal channels happen to be loopholes for global terrorism and corruption. Money laundering and terrorist financing are among the growing criminal activities in East Africa and the Greater Horn region. Money laundering and terrorist financing are transnational, cross-border, multifaceted, and complex problems that require cooperation and coordination among actors looking to successfully respond to them. Not only do money laundering and terrorist financing negatively affect the integrity and stability of the financial sector, but they also undermine national security and economic development goals.[261] Informal flows will open doors for illegal activities. People may use it to collect huge sums of money for their own dangerous acts, says Ethiopian Financial Security Director General Gemecu Weyema.[262] Informal flows in addition to preventing the government from tracking money laundering and terrorist financing; it also reduces the opportunities to encourage investment.[263]

For Ethiopia, AML/CFT efforts are important for strengthening the integrity of the financial sector, macroeconomic stability, and national security.[264] Nevertheless, despite the important improvements Ethiopia has made and is progressively continuing to achieve, concerns remain

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[259] www.businessdictionary.com/definition/money-laundering.html (last accessed May 13/2018)

[260] Leon Issacs, *The Executive Summary of a Research Study* , ,p 6

[261]Tu'emay Aregawi Desta,the *Anti-Money Laundering and Countering Terrorist Financing Regime in Ethiopia*, Second Assessment Report,February 2014, p 1[Herein after Tu'emay Aregawi Desta,*the Anti-Money Laundering and Countering Terrorist Financing Regime in Ethiopi*a]

[262] Desta G/hiwot , 'Informal channels raise red flag on forex earning', online, *The Ethiopian Herald;* http://allafrica.com/stories/201709140729.html (last accessed April 23/2018

[263] *Ibid*

[264]The NBE applies customer due diligence standards across all banks and supervises the financial sector's compliance activities as required by law. Ethiopia's Financial Intelligence Centre (FIC) began receiving cash transaction reports (CTRs) and suspicious transaction reports (STRs) from the banking community in January 2012. Furthermore, Ethiopia became a party in March 2012 to the International Convention for the Suppression of the Financing of Terrorism; in February 2013, it published Proclamation 780/2013, "Prevention and Suppression of Money Laundering and Financing of Terrorism." With regular AML/CFT trainings being led by the FIC, Ethiopia is taking important steps in improving compliance with the recommendations established by the Financial Action Task Force (FATF) with the goal of being removed from FATF's list of jurisdictions subject to on-going global AML/CFT compliance processes. See Tu'emay Aregawi Desta,*the Anti-Money Laundering and Countering Terrorist Financing Regime in Ethiopi*a

regarding inadequate addressed sections of the AML/CFT framework. The potential AML/CFT risk stems from the significant use of informal value transfer systems which Ethiopia is encountering.[265]

The Proclamation 780/2013[266] supported by institutional strengthening, operational improvements, and enhanced collaborations, will help Ethiopia more effectively respond to international obligations and enable the country to better counter money laundering and terrorism financing and related criminalities.[267]

The Federal Police and the Federal State Prosecutor have investigated and prosecuted cases of terrorism financing and money laundering. Statistical reports from the Ministry of Justice revealed that, between 009–2010 and 2011–2012, 126 cases of terrorism financing have been investigated or are in the process of being prosecuted. During the same period, 141 cases of money laundering have been investigated and prosecuted.[268]

Foreign exchange controls may increase money laundering and terrorism financing risks for Ethiopia when individuals, particularly immigrant workers, and businesses seeking to operate internationally need to find alternative means of managing their foreign exchange needs. These alternative means are difficult for the authorities to monitor and track. Tight foreign exchange control led to the growth of parallel unregulated market which has the potential to increase socio economic ills like money laundering and terrorism financing.[269]

At a more individual level, foreign exchange controls limit the ability of a population to travel overseas, an important component of international trade and business development that is needed to boost a country's exports and secure the resulting foreign exchange, trade deficit reduction, and overall economic benefits. [270]A less restrictive foreign exchange regime is likely to

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[265] Tu'emay Aregawi Desta,the *Anti-Money Laundering and Countering Terrorist Financing Regime in Ethiopia* , p 1

[266]Prevention and Suppression of Money Laundering and Financing of Terrorism Proclamation, 2013, Federal Negarit Gazette, Proc. No.780, 19th Year, , No. 25,

[267] Tu'emay Aregawi Desta,the *Anti-Money Laundering and Countering Terrorist Financing Regime in Ethiopia* , p 1

[268] *Id* p 5

[269] Kenedy Abebe :'Ethiopia: Foreign Exchange Crunch Now, Then, Tomorrow' ,online, *Addis fortune*, September 2017 https://addisfortune.net/columns/foreign-exchange-crunch-now-then-tomorrow/ (last accessed April 17/2018)

[270] Tom Kiantige, *Growing an Economy*, P 3

encourage remittances to flow in greater volume through the regulated financial sector, thus reducing AML/CFT risk.[271]

The preamble of Anti money laundering and controlling financing terrorism proclamation, proc no 780/2013, states that creating transparent financial system is the one of the reasons for the necessity of the proclamation. However under the current legal system, the parallel market is illegal and excluded from Ethiopia's foreign exchange regulation. As a result the operation of the parallel market is not transparent. The greatest AML/CFT risk facing Ethiopia is coming through remittance entering the country and the economy via unregulated routes that are partially encouraged by the structures of the country's foreign exchange regime which is difficult for the FIC and other authorities to monitor and assess.[272] A more open foreign exchange regime would likely translate into a reduced need for foreign currency to be smuggled into the country.[273] Together with the underdevelopment of the private banking sector and the extensive flow of remittances into the country, these controls create a potentially significant weakness in Ethiopia's AML/CFT defenses.[274]

3.6 Reduced flow of remittance to the formal channel (Losing huge private transfer)

As discussed in the previous chapter, remittances are a significant contributor to the Ethiopian economy and can help accelerate the country's development.

Migrants make important economic, developmental and cultural contributions to sending and receiving countries through remittance. Remittances from migrants have positive impacts on poverty reduction and development substantially contributing to the achievement of development goals. These positive impacts become greater when remittances can be saved and invested in infrastructures and productive capacity .[275] Unfortunately however, Ethiopia is not getting half of this important source of foreign currency. IMF data suggest that remittances and official transfers represent more than 4 percent of Ethiopian gross domestic product, with estimates of

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271 Tom Kiantige, *Growing an Economy*, P5

272 *Id* p 4

273 Tom Kiantige, *Growing an Economy*, P 3

274 *Ibid*

275 *Maximizing the development of remittances*: UN conference on trade and development, trade and development board ,Expert Meeting on Maximizing the Development Impact of Remittances: Geneva, 14–15 February 2011 Item 3 of the provisional agenda, p 1 [Herein after, *Maximizing the development of remittances*: UN conference on trade and development]

remittance values ranging from $387 million to $3 billion. This range partly reflects the difficulty in measuring these flows due to the significant use of informal remittance channels as a result of an underdeveloped banking industry and, likely, the tight foreign exchange control regime that the country imposes.[276]

NBE data indicate that imports surged 87 percent between 2004/2005 and 2007/2008, with half of the required funding for these imports coming from "Private Transfers," including remittances, whereas less than 20 percent was covered by export earnings. Thus, although these remittances have an important personal value to the recipients, they play a critical role in Ethiopian development. Another important national aspect to remittance receipts is the positive contribution they could make to the weak national foreign exchange reserve position. The ability of remittances and other transfers into the country to bolster the nation's financial position is considerable. Ensuring these flows pass through the formal banking sector is of high, positive value to the national economy.[277]

The country's foreign exchange control regime risks hindering broad economic development and is likely reducing the value of remittance flows. [278]The Ethiopian leadership and government have delivered growth and progress in recent years. Imposing foreign exchange controls, however, is almost certainly leading to the growth of a parallel, unregulated market that has the potential to challenge or reverse much of this notable progress.[279] Ethiopia may continue to grapple with shortage of hard currency unless swift and collective measures are put in place.[280]

Significant barriers to migration and remittance transfers need to be addressed in order to harness opportunities for development and poverty reduction, including easing financial transfers, setting appropriate incentives, improving policy coherence in migration and remittances policies, and facilitating the temporary movement of people.[281] The government must create a mechanism to fetch such huge financial resources towards the official channel.[282]

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[276] *Maximizing the development of remittances*: UN conference on trade and development,p1
[277] Tom Kiantige, *Growing an Economy*: Impact , p3
[278] *Id.,* p 4
[279] *I.,d* p 5
[280] Desta G/hiwot , 'Informal channels raise red flag on forex earning', online, *The Ethiopian Herald;* http://allafrica.com/stories/201709140729.html (last accessed April 23/2018)
[281] *Maximizing the development of remittances*: UN conference on trade and development, p1
[282] Tefera Lemma, *Determinants of Parallel Foreign Exchange Market in Ethiopia,* p 30

CHAPTER FOUR

Ways of Enforcing the Foreign Exchange Regulation in the Parallel Market

The NBE establishment proclamation, proclamation NO/591/2008 leaves two ways of enforcement on the parallel market. Either making the parallel market illegal by using the first interpretation of Article 20(1) of the proclamation which stated that: "*No person shall engage in any transaction of foreign exchange except with banks or authorized dealers or with the special permission of the National Bank*." So far the NBE authorized only banks to engage in foreign exchange transaction. Since parallel market dealers are not authorized, they are taken as illegal activity which is punishable under the proclamation and criminal code of Ethiopia. The other way of enforcement is authorizing the parallel market dealers using the same provision and letting them to work and let the government trace, control and regulates them. The researcher discusses the two ways of enforcing the foreign exchange regulation on the parallel market, the efforts the government has been doing to avoid the problem and analyze whether the effort is effective.

4.1. Efforts o shut down the Parallel foreign exchange market in Ethiopia

4.1.1 Legal measure

As many other less developed countries, the imposition of foreign exchange control in Ethiopia promoted the growth of a parallel foreign exchange market. [283]If the supply of foreign exchange in the official market is insufficient to satisfy the demand for it at the official exchange rate, excess demand for foreign currency is created in this market. If the concerned body of the government does not react to this excess demand, it will result in the emergence of the parallel foreign exchange market.[284]

Strict foreign exchange control result in alternative means of foreign exchange transactions in order to satisfy the excess demand that can't be fulfilled in formal market. [285]Ethiopia is among countries which impose strict foreign exchange rule. As the researcher discussed in chapter two of this paper, there is high restriction on the foreign exchange regime which resulted in parallel foreign exchange market in the country.

As a result, importers, internal traders, foreigners and the other part of the people need other alternative means of getting foreign currency. The government of Ethiopia makes these alternatives of buying and selling of foreign currency illegal since the time it was born in the Derg regime.[286] It is almost more than four decades since it is started and is active market still now. The issue here is why the parallel foreign exchange market remains active for decades despite their illegality and harsh penalty in the criminal code of Ethiopia? The harsh penalty had never stopped the people from bringing dollar into the country and selling it at a much higher value.[287]

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[283] Pierre- Richard Agenor, *Parallel currency markets in developing countries* ,p 5

[284] Deresse Degefa, *The parallel foreign exchange market and macro economic performance in Ethiopia*, p 15

[285] Pierre- Richard Agenor *, Parallel currency markets in developing countries*, p 5

[286] Article 2(4) of Regulation no 1977 authorizes only banks to engage in foreign exchange transactions.

[287] Interview with Ato Tibebe H/giorgis, Vice director of foreign exchange monitory and reserve management director of NBE, April 15/2018

The logical and obvious implication is that if parallel markets emerge in response to the imposition of controls, the most effective remedy is to eliminate the restrictions.[288] The existing control could not stop the parallel market operators from participating in illicit trade and capital flight. This can be witnessed by the very existence of the market together with excessive control, in the Derge regime.[289] Parallel market is not something to be avoided by strong control and monitoring. For the strong control, no one can be compared with the Derg regime. But the market still persists even more than ever.[290] Parallel market disappears if and only if the export sector is diversified and its proceeds able to finance all the foreign currency demand of the country.[291]

The government can't satisfy the excess demand of the people for several reasons. Without fulfilling the excess demand for foreign currency, prohibiting the people from using alternative means seems illogical and is of course the basic reason for failure of this trial for more than four decades.

This situation obviously calls for other policy measure that can help the country at least in reducing the problem significantly. The same opinion is given by the director of NBE. It is hardly possible to avoid or minimize the parallel market transaction by punishing the parallel market dealers. If so, they wouldn't be seen in front of NBE. Since prisoning and making them criminally liable is fruitless, now NBE is trying to stop or at least reduce the parallel market transaction through different policy measures.[292]

On the other hand, the vice commissioner of Addis Ababa police commission opined that, the parallel foreign currency market is illegal in Ethiopia. However it is being practice in known areas. The enforcement is weak in these days. During 1997 in Ethiopian calendar, the enforcement was strict and almost parallel market was disappeared. Of course these days the police are reluctant in this area. He added that it is the failure of the police for the proliferation of the parallel market. If the police work hard, it is not difficult to stop them. It is just like another

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[288] Pierre- Richard Agenor , *Parallel currency markets in developing countries*, p 18

[289] Tefera lemma, *determinants of parallel foreign exchange market in Ethiopia*, P 30

[290] Interview with Ato Tibebu H/Ghiorgis, Vice-Director of Foreign Exchange Monitoring and Reserve Management Directorate of NBE held in April 15/2018

[291] *Ibid*

[292] Interview with Ato Abebayehu Rufira, officer in External sector research department in NBE ,April 12/2018

crime which can be controllable. We know where they work and everybody knows. It is the failure of the police to monitor and expose the dealers.[293]

The researcher discusses the policy measures taken by NBE to reduce the parallel market as follows.

4.1.2 Other policy measures to combat the parallel foreign exchange market

4.1.2.1. Devaluation

In modern monetary policy, a devaluation is an official lowering of the value of a country's currency within a fixed exchange rate system, by which the monetary authority formally sets a new fixed rate with respect to a foreign reference currency or currency basket. A currency devalues when its value declines in relation to one or more other currencies. Usually countries devalue their currency to try to boost their exports and decrease their imports. [294]

NBE devaluates the Ethiopian birr by 15% in October/2017. The rational for the last year devaluation in addition to enhancing export is to minimize the parallel foreign exchange market by narrowing the premium gap between formal and parallel market rate.[295] One of the policy measure taken by the NBE as a regulatory organ is devaluating Ethiopian birr. It was done to approach the rate of black market so that to divert the people to the official market. Even though the National Bank of Ethiopia (NBE) has taken this measure to stop parallel market trading of foreign currency, the price difference between foreign currency on the parallel market and in the banks again increased more than ever. [296]

Despite the fact that the government devaluated the birr by fifteen percent against major hard currencies on October 11, 2017 which meant that it was the same as the black market rate, the black market returned the favor and went up as well. The current gap between the legal market

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[293] Interview with Ato Simon Fenta, Vice commissioner in Addis Ababa police commission ,April 17/2018

[294] Dictionary of financial terms , https://www.thestreet.com/topic/46324/devaluation.html,(last accessed April 21/2018)

[295] See Pierre- Richard Agenor, *Parallel currency markets in developing countries*. Regarding black market premium, several countries have taken a half-way approach. For instance, while maintaining exchange controls, the Chinese financial authorities take into account the black market rate of exchange in setting the official exchange rate. The major aim of such a policy is to provide incentives for people to keep money in the banks.

[296] Interview with Ato Abeyehu rufera, officer in the external sector Research department of NBE, April 12/2018

and the parallel market has reached up to 25 percent, the highest it has ever been. [297]It is for the first time that such high devaluation is made in Ethiopian history but it is also for the first time that with this high devaluation, the black market becomes more active. Now, hard currency sellers are getting over 34 and 35 birr for a dollar from the illegal forex market.[298]

Experts are confused about this because the devaluation was expected to solve this problem in December last year. The law was expected to stop illegal remittances exchanged based on the rate of the black market. Despite devaluation, black market dollar rate gap highest ever.[299] The NBE was hoping this measure to reduce the problem significantly. However devaluating the money becomes fruitless even fuel the black market by increasing the rate.[300]

4. 1.2.2. Enhancing Incoming remittance transfers

Migration is a win-win pro-development opportunity for origin and destination countries. Empirical evidence indicates a positive correlation between remittances, development, and poverty reduction. Remittances have, if properly harnessed, multiplier effects on economic and social development. Proactive policy measures could induce the productive use of remittances and capitalize on Diaspora networks for developmental purposes.[301] However, the informal transfer system so called 'hawala' the other face of parallel market, becomes the main channel of money transfer system for most Ethiopians abroad. The Government of Ethiopia can't have the foreign currency through remittance.

Ethiopian migrants abroad are either legal migrants (documented) or undocumented (illegal migrants). There are two distinct customer segments in the informal private transfer or *'hawala'.* The first are undocumented migrants in countries where undocumented migrants are not able to send money due to their immigration status. The second are documented migrants (particularly in Europe and North America) who are able to use formal channels, but who, for a variety of

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[297] Muluken Yewondwossen: 'Despite devaluation black markets dollar rate gap highest ever', online, *Capital news*, http://capitalethiopia.com/2018/02/26/despite-devaluation-black-market-dollar-rate-gap-highest-ever, (last accessed April 12/2018)
[298] Interview with Ato Dereje Getahun, Manager of foreign exchange department in the Awash international bank head office , April 18/2018
[299] Muluken Yewondwossen: 'Despite devaluation black markets dollar rate gap highest ever', online, *Capital news*, http://capitalethiopia.com/2018/02/26/despite-devaluation-black-market-dollar-rate-gap-highest-ever, (last accessed April 12/2018)
[300] Interview with Ato Abebayehu rufera, officer in External sector research department of NBE April 12/2018,
[301]*Maximizing the development of remittances*: UN conference on trade and development, p 20

reasons, choose not to do so.[302] The reasons not to choose the formal channel by the documented migrants are:[303]

-Lack of convenient access to formal remittance pay-out channels in rural areas remains a challenge in Ethiopia despite remarkable improvements in the last few years

-Costs of using formal channels compared to informal services; Interviews with stakeholders and Diaspora groups suggest that this is the single greatest factor in the reluctance to use formal remittance channels

-Indirect cost- such as the cost of transport and the time taken to get to the remittance pay-out location, including time taken to wait in queues

-Speed of service – particularly to rural areas

The NBE enacted a directive[304] as an effort to improve the operations of the formal remittance transfer system in Ethiopia by reducing remittance costs and increasing access to cost effective, reliable, fast and safe services[305] that benefit migrants.[306]

The directive introduced different Remittance Service Providers (RSP)" and defined it as a licensed business organization that provides remittance service to customers either directly by banks or through money transferring agents working in association with banks. These RSPs include; International money transfer operators, Commercial banks (Bank-to-Bank transfers through SWIFT and other media. "Money transferring agent" is referred as a business organization having a valid license issued abroad that captures or distributes remittance transfers in association with domestic banks and others to be specified by NBE.[307]

International Remittance transfer by nationals is a monetary transfer that overseas Ethiopians and foreign nationals of Ethiopian origin make to their home country, Ethiopia. These transfers may include Personal transfers, Money to be used for investment, donation, deposit and service

[302] Leon Isaacs**:** *The Executive Summary of a Research Study,* p 17

[303] *Ibid*

[304] Directive No FXD/30/2006, Provisions for International Remittance Services,[Herein after, FXD/30/2006]

[305] Remittance Service refers a service that enables customers to send and/or receive fund transfers as per article 1.2 of FXD 30/2006

[306] The Preamble of FXD/30/2006

[307] FXD 30/2006, Article 1.4

payments, Temporary and permanent migrants' transfers.[308] The directive allows "Non-Financial Organizations" to engage in remittance services through their branches overseas. These are; Ethiopian Airlines (EAL) Ethiopian Shipping Lines (ESL)[309] "International Money Transferring Operators" are internationally licensed and regulated business organizations that provide money-transferring services internationally. These include; Western Union, MoneyGram, Maniflo, Adam Funds etc. [310]International money transfer operators in association with banks, Commercial banks and Non-financial organizations are eligible to provide low cost international remittance service in Ethiopia.[311]

Furthermore as an incentive to encourage formal remittances, the Directive mandated zero commission in local banks for the pay-out of remittances.[312] In recent years also, the commercial banks started remittance lottery to encourage formal remittance. These are the only incentives provided in Ethiopia to increase formal remittance which is the main source of foreign currency even more than export. Despite the intention of the directive, informal networks remain prominent ways for Ethiopians abroad to send money back home.[313] Considering the positive contribution of remittances to the weak national foreign exchange reserve position and to bolster the nation's foreign currency, ensuring these flows pass through the formal channel is of high, positive value to the national economy.[314]

Other Governments give different assistance, including credit provision and incentives that significantly induce migrants and Diasporas to invest in home countries. Brazil, Morocco, India, Ecuador, Philippines and Mexico are good examples that Ethiopia must take lesson from.

Supported by the Inter-American Development Bank, Brazil established a Mutual Fund for Investment in Emerging Enterprises (the "Dekassegui Fund") in the early 2000s, aimed at channeling a small portion of regularly transferred remittances to more productive uses. The fund offers support to Brazilians abroad (principally those in Japan) hoping to open small businesses in Brazil. This support includes selection and training of potential entrepreneurs in Japan; integration and business training in Brazil; and start-up and growth of new businesses. The funds

[308] FXD 30/2006 Article 1.1

[309] FXD 30/2006 Article 1.1

[310] FXD 30/2006 Article 1.1

[311] FXD 30/2006 Article 2.1

[312] FXD 30/2006 Article 3.2.3

[313] Desta G/hiwot , 'Informal channels raise red flag on forex earning', online, *The Ethiopian Herald;* http://allafrica.com/stories/201709140729.html (last accessed April 23/2018

[314] Tom Kiantige, *Growing an Economy* , p3

also provide microcredit for start-up businesses, for example in restaurants, food processing, and agribusiness. [315]

In Morocco, the Groupe Banques Populaires is a state-owned bank with branches in several European countries. Receiving about 60 per cent of all remittances to Morocco, it provides subsidized credit for real estate and entrepreneurial investments in Morocco. Bangladesh has announced the creation of an expatriate welfare bank to provide collateral free loans, in particular to returnees, as well as support for investment in productive sectors of the economy.[316]

The Indian Government is presenting an ambitious $500 billion national infrastructure project to overseas Indians in more than 50 countries.27 Indian diasporas will participate through public–private partnerships that will include knowledge and financial contributions from them.28 If successful, this model could open a new way to finance significant infrastructure projects by diasporas interested in promoting development and higher standards of living in their countries of origin. [317]

Ecuador set up an institutional mechanism in 2007 that could facilitate such coherence in countries of origin. The government is in charge of all policies related to migration and remittances, with competence at the national and international level. It has signed cooperation agreements with local institutions, including tax authorities, banks, the post office, the national civil register, and universities, to provide tax incentives (e.g. tariff exemptions for returning migrants' housing and working equipment) and services of interest to migrants. It has introduced facilitated migrant return programs that provide business plan design, training, and seed capital provision. A bank for migrants to provide low-cost transfers and soft credits is also planned. [318]

Some countries, such as Mexico and the Philippines, allow migrants to contribute to the national pension and healthcare schemes regardless of their access in destination countries. Many migrants consider returning home after some time, or at retirement age. Encouraging coverage and payments to the social security system to workers abroad could incentivize social investment in pension and health insurance, with benefits upon retirement. Non-portability of contributory

[315] *Maximizing the development of remittances*: UN conference on trade and development, p13
[316] *Ibid*
[317] *Ibid*
[318] *Ibid*

pensions not only discourages return and circular migration due to the impossibility of accumulating benefits, but also reduces the amount of remittance money that can be sent home. Solutions to address the portability issue51 include unilaterally allowing full or partial portability, and bilateral agreements seeking to avoid double contribution of social benefits in both origin and destination countries.[319]

Mobile banking can help increase both affordability and accessibility. In many parts of Asia and Africa, mobile phone companies are developing ways of transferring money to remote parts of the country. Under the money transfer arrangement between Vodafone Qatar and Philippines-based Globe Telecom, 200,000 Filipinos working in Qatar will be able to send money to the Philippines. A United Kingdom telecom operator in Kenya, has launched broad financial mobile services to facilitate the transfer of workers' remittances. It has more than 7 million subscribers, generating more than $88.5 million worth of transactions daily. Efforts are also being deployed by France and French-speaking Africa in identifying regulatory challenges to allow remittance transfers via the internet and mobile phones.[320]

4.1.2.3 Foreign currency Account

In 2006, the NBE introduced Directive No. FXD/31/2006, allowing the opening of foreign currency accounts for nonresident Ethiopians. The aim of this Directive is to create incentives for Ethiopians abroad to invest domestically, as well as to improve Ethiopia's international foreign exchange reserves. Foreign currency account has been allowed for nonresident Ethiopians and non- Ethiopians to maintain foreign currency account at home country so as to encourage domestic investment; international foreign exchange reserve; to ease the balance of payments problem of the country and also to encourage foreign direct investment.[321]

The Directive allows accounts for the Ethiopians abroad to be maintained in USD, GBP (pound sterling) and EUR (euro).[322] However Banks may accept deposits in other convertible currencies that include Canadian Dollar, Saudi Riyal, Japanese Yen, Australian Dollar and UAE Dirham.

[319] *Maximizing the development of remittances*: UN conference on trade and development, p1319 -20
[320] *Id.,* p17
[321] Preamble of FXD/31/2006, Amendment to Directive No. FXD/25/2004 Establishment and Operation of Foreign Currency Account for Non-Resident Ethiopians and Non-Resident Ethiopian Origin[Herein after FXD 31/2006]
[322] FXD/31/2006, Article 5.1

And, these other currencies shall be converted to any of the three currencies enumerated under above at spot exchange rate based on the preference of the account opener.[323]

These accounts can be used to make foreign payments for imports (provided the account holder has the required business license), make local payments in Birr, to transfer to other foreign currency accounts, which may include transfer to another.

It can also be used to make transfer abroad; to convert into a Birr account at the ruling exchange rate. It also serves as collateral or guarantee for loans or bids[324]. The problem is foreign currency account is also used by those who are not Diasporas. People use their relative foreign currency account to deposit foreign currency.[325] In doing so, Diasporas are cooperating parallel market users by saving others foreign currency sourced from parallel market. Amazingly, the foreign currency account is assisting the parallel market user which is the reverse intent of NBE.[326]

4.1.2.4 Different incentives for Exporters to avoid shortage of foreign currency

Export diversification has been the concern of most developing countries including Ethiopia in order to raise capacity utilization and increase total export proceeds.[327]

Export promotion policies and strategies have long been used by many countries to increase export and stimulate export led economic growth through the creation of internationally competitive export sector. The importance of export on economic and social wellbeing is widely documented. Exports are the main sources of foreign exchange, reaping economies of scale and specialization, and accessing new technology.[328]

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[323] FXD 31/2006, Article 5.2

[324] FXD 31/2006, Article 7

[325] Interview with Ato Eyob Abraham, Manager of Awash international bank, Merkato branch, March 29/2018

[326] Interview with Zelalem Getnet, officer in the external sector research department of NBE and and Betre Mekonnen ,Customer service officer in the Ethiopian commercial bank, Mahatema ghandi branch, May 25 and 26 /2018 respectively

[327]Berhanu Lakew, *Prospects forexport diversification in Ethiopia*, NBE economic research department, NBE staff working paper, ERD /swp/007/2003, May 2003, p4 [Herein after, Berhanu Lakew, Prospects for export diversification in Ethiopia]

[328] Mulu Gebreyesus and Ashagrie Demile, *Why export promotion efforts failed to deliver*? *Assessment of the export incentives and their implementation in Ethiopia* ,Ethiopian Development Research Institute (EDRI), Ethiopia EDRI Working Paper 17, July, 2017 p 3[Herein after , Mulu *Gebreyesus and Ashagrie Demile,: Why export promotion efforts failed to deliver?*]

Ethiopian export is dominated by few raw or semi processed agricultural products which have been the main contributors to the country's foreign exchange earnings. Low levels of industrial development with limited volume and quality have continued to inhibit competiveness and market needs in the international market. Lack of diversification in the export of commodities and dependence on monolithic commodity export (coffee) characterizes the overall nature of national commodity export.[329]

Lack of competitiveness regarding efficiency, inputs, technology, and product design, specifically in leather and textile products, management, training, high overhead costs as well as inability to produce export standard commodities are some of the challenges of the export sector that are to be resolved effectively. [330]

Moreover, absence of export marketing skills and limited managerial and technical capabilities in the private business sector, low market promotion schemes; lack of trained manpower on international marketing intelligence are also the other problems. Inability to access information on latest technologies regarding raw material needs and foreign trade opportunities need to be effectively addressed. Incapability of transforming the raw export items into processed or finished products by adding asserts to the products has subjected Ethiopia to huge loose of foreign exchange earnings which the nation could have claimed.[331]

In order to solve such problems, Ethiopia provides a range of export incentives in addition to investment incentives it gives to all investors.[332] What motivate decision of firms whether to export or sale in domestic market is not the export incentives but the levels in relation to the incentives available to producers for domestic sales. [333]The researcher discusses what additional incentives are available for exporters above firms producing for domestic market in a given sector and their effectiveness in motivating exporters and enhancing foreign currency.

4.1.2.4.1. Exemption of duty/tax on inputs

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[329] Solomon Dibaba,'Tackling challenges in the Ethiopian export industry' , online, *The Ethiopian herald,* http://www.ethpress.gov.et/herald/index.php/technology/item/2429-tackling-challenges-in-the-ethiopian-export-industry(last accessed May 27/2018)

[330] *Ibid*

[331] *Ibid*

[332] Berhanu Lakew, *Prospects forexport diversification in Ethiopia* 14

[333] Mulu Gebreyesus and Ashagrie Demile, *Why export promotion efforts failed to deliver*? p 3

To ascertain that exporters have access to inputs at world market price and make them competitive in the global market, the government of Ethiopia has exempted exporters from paying duty/tax on inputs. The country has introduced different types of incentives that include Duty Drawback (DDB); the Voucher; and Accelerated Duty Drawback (ADDBS) in the new proclamation titled as a proclamation on export trade duty incentive schemes enacted in 2012.[334]

A. Duty Drawback (DDB)

Duty drawback is one of the export incentives that Ethiopia has started to provide as early as 1993.[335] This incentive allows firms importing raw materials for use in the production of an export good to receive 100% refund of the customs duty and tax payments made once the final product is exported.[336] It has been adjusted through time. According to the recent Export Trade Duty Incentive Schemes Proclamation, Proclamation No. 768/2012, the beneficiaries of the scheme are direct and indirect exporter and producer who are engaged in producing commodity and supplying same in whole, in part or periodically to foreign market. [337]But products produced using these imported inputs should be exported within a year of the inputs imported and duty paid claimed should be no less than Birr 1,000. Duty paid less than Birr 1,000may not be refunded.[338]

B. The Voucher scheme

[334] Export trade duty incentive schemes proclamation, 2012,Federal Negarit Gazette, Proc. No. 768, 18th No 62 [Herein after , proc 768/2012]

[335] As per Article 2(1)and 2(2) of proc 768/2012 "duty draw-back" means duty paid on raw materials and accessories used in the production of commodities and refunded to the payer upon exportation of the commodity processed; And "duty" means any indirect tax or duty payable on raw materials and commodities or accessories imported or produced locally;

[336] Proc 768/2012 , Article 5

[337] Proc 768/2012 Article 4

[338] Proc 768/ 2012 Article5(2)

This was also introduced in 1993. It allows exemption of duty/tax on inputs used for the production of export products.[339] Unlike the above one, the voucher scheme does not require beneficiaries to pay tax and duty on imported input at the time of import. This addresses the working capital shortage prevalent under the duty drawback scheme. Under this scheme exporters are given a voucher book, which has monetary value equal to the amount of taxes and duties payable on inputs the exporter would like to import for the production of export commodity. Raw materials imported under the voucher scheme shall be used in the production of export commodity and the commodity so produced shall be exported within one year from receipt of such raw materials by the beneficiary[340]

C. The accelerated duty drawback schemes (ADDBS)

Accelerated duty drawback scheme is the other means of getting duty/tax drawback for domestically purchased inputs. The scheme was introduced in 2004 and aims to ensure backward linkage of the industry particularly with agricultural sector by encouraging value addition in input supply chain, and eases the pressure on working capital shortage of exporters. The requirement to be the beneficiary of the ADDBS is simply to be an exporter and contribute to the country's foreign exchange earnings. In this scheme, exporters will get the duty/tax drawback within seven days of their application without confirming that the products produced using these inputs are exported. Nevertheless, the beneficiaries of this scheme should submit evidence that the product produced using locally purchased input is exported or sold to exporter producer as an input within three months from the date the duty drawback is made together with other documents required by ERCA.[341]

The first and major problem on the part of the implementing agencies is that there is no standardized input-output coefficient (IOC) which can be used for the calculation of duty and tax refunded to exporters.[342] According to Proclamation 768/2012, the Ministry of Industry (MoI) was given the responsibility to issue and implement directive concerning IOC within two years from the effective date of the proclamation.[343] Until then, IOC presented by producers was

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[339] Mulu Gebreyesus and Ashagrie Demile, *Why export promotion efforts failed to deliver ?* p 13
[340] Proc no 768/2012 , Article 9
[341] Mulu Gebreyesus and Ashagrie Demile, Why *export promotion efforts failed to deliver*? p 13
[342] "input output coefficient" means a specified measurement for the use of raw material or accessory to produce one unit of export goods; Article 2(14) of proc 768/2012
[343] Proc 768/2012 , Article 22

supposed to be reviewed and approved by the Ministry pending the issuance and implementation of the directive. After four years of the issuance of the proclamation, however, Ministry of industry has prepared standardized IOC for two sectors only: textile and garment, and leather industries. According to some evidence, even for the sectors for which there exists standardized IOC, it lacks details and doesn't fit into firms' particular demand. Thus the IOC is being updated continuously based on exporters' requests.[344]

The determination of a new IOC and the reconciliation process is cumbersome and time taking, and entailing extra costs for exporters. Currently, of the total of 42 exporters who have submitted a request for IOC determination over a year, only 15 of them have got a response and the rest, 27 of them, are still waiting the decision of Ministry of trade. This delay concerns not only DDB users but also reconciliation in voucher scheme. The average waiting days for firms to get the final decision on the reconciliation of the duty and tax is very long, i.e., 77 days. The continuous revision of IOC and the lengthy process of reconciliation are partly caused by the lack of sufficient manpower and the use of manual based systems instead of information technology (IT) based system to administer export incentives. For instance, the Directorate at Ministry of Industry which administers export incentive does have only eight staff of the 25 staff required under different positions. IOC determination involves opinion of experts who are working in Ethiopian Textile Industry Development Institute (ETIDI), and Leather Industry Development Institute (LDI). Getting expertise opinion takes long time as this may involve visit of applicants' factories and the experts take this assignment as extra work. After obtaining experts opinion, discussion will be held among the national inventive determination committee members from Ministry of trade, Ministry of finance and economic cooperation, Ethiopian revenue and customs authority, and Ministry of Trade with the presence of the expert/s and the decision of the committee will be send to the ministry of Industry for the final decision. But committee members do not meet on regular basis to decide on the issue. [345]

4.1.2.4. 2. The Industrial Zone Scheme (IZ)

Industrial Zone means an area set aside for industry which is equipped with the necessary infrastructural facilities and enjoys policy incentives.[346] This incentive aims at improving

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[344] Mulu Gebreyesus and Ashagrie Demile,: *Why export promotion efforts failed to deliver ?* p12
[345]*Id* p13
[346] Proc 768/2012 Article 2(9)

infrastructure and customs service for exporters. The establishment of an industrial zone (IZ) is expected to attract foreign direct investment (FDI) and promote exports since it reduces the cost involved and the time it takes to construct production facilities.

In the proclamation, the MoI is entrusted to issue directive stipulating the criteria to be fulfilled by industries to become beneficiary of the industrial zone scheme.[347]Raw materials imported by the beneficiary of the IZ scheme shall be transported from a customs post to the factory under the control of customs without being subject to payment of duty. [348]The imported raw materials need to be used for production of commodities (for export or local consumption) within one year of receipt of such raw materials by an industry within the zone.[349] At the moment, there are at least two cavities compromising the effectiveness of the industrial park scheme in promoting exports. First, the industrial parks are at their initial stage. Currently there are only four operational industrial parks in Ethiopia, namely – Eastern Zone, Bole Lemi, Hawassa and the Information Technology (ICT) Park located in Addis Ababa. Two private industrial parks, (Gorge Shoe IP and Huwajan IP) and other five governments owned Industrial parks (Hawassa No.2, Adama, Kombolca, Arerti and Mekelle) are also under development. Second, although quite a number of firms (IP enterprises) are operating in the IPs, the directive and regulation necessary for the implementation of the proclamation are not yet operational.[350] The absence of such regulations created a gap in infrastructure development and the provision of other facilities such as banks and customs services within the park.[351]

4.1.2.4.3. Retention and utilization of foreign currency earned by exporters

The only Ethiopian residents who are allowed to have foreign currency account is exporters.[352]Those exporters who have fully settled his/her foreign exchange commitments with the National Bank of Ethiopia (NBE), have retention rights by opening forex retention

[347] Proc 768/2012 Article 13(2)
[348] proc 768/2012 Article 14 (1)
[349] Proc 768/2012 Article 14 (3)
[350]Article 32(1)/ The Council of Ministers may issue regulations necessary for the implementation of this Proclamation.
2/ Without prejudice to the powers of other public bodies to issue directives in respect of matters specified in this Proclamation, the Ministry of Finance and Economic Development may issue directives necessary for the implementation of this Proclamation and regulations issued under sub-article (1) of this Article. Yet there is no regulation and directives for the implementation of the proclamation.

[351] Mulu Gebreyesus and Ashagrie Demile,: *Why export promotion efforts failed to deliver* ,p 17
[352] Interview with Ato Betre Mekonnen, customer service officer in commercial bank of Ethiopia, Mehetema Ghandi branch, May 26/2018

accounts.[353]Forex retention account is a foreign currency account maintained by eligible exporters [354]of goods and services and receives foreign exchange transfer from abroad.[355]The exporter shall open two types of forex retention accounts, Account A and B, in local banks.[356]Such accounts shall not be credited from any other sources except from export earnings.[357] The amount that eligible exporters can keep in these accounts has changed through time. Initially, eligible exporters had the right to retain 30% of their foreign currency export earnings in retention account; that is 10% in Account A and 20% in Account B. The remaining 70% of their export earnings shall be surrendered to NBE at the prevailing marginal exchange rate within two days of the receipt. Exporters were also free to sell the balance in the retention Account B at a negotiated rate at the end of the period allowed to maintain the balance in the same account. [358]

The above directive, however, was repealed twice using the Retention and Utilization of Export Earnings and Inward Remittances Directives Nos.FXD/04/1996[359] and FXD/11/1998[360]. These revisions have changed the foreign currency amount and the period for which exporters are allowed to maintain the foreign currency in their retention accounts.

Under the FXD/04/1996, eligible exporters were allowed to retain fifty percent (50%) of their export earnings and remittances to deposit in foreign currency in retention Accounts A & B. [361]While (10%) of the foreign exchange earnings or remittances shall be deposited in forex retention account A of an eligible customer,[362] forty percent (40%) of the foreign exchange earnings or inward remittances deposited in Forex Retention Account B of an eligible customer.[363]

[353] Article 5 of Directive NO FXD 48/2017, Directive for amendment of retention and utilization of export earnings and inward remittances; Directive No fxd 11/1998[Herein after , FXD 48/2017,]
[354] Those exporters who have fully settled his/her foreign exchange commitments with the National Bank of Ethiopia (NBE)
[355] FXD 48/2017, Article 2(1)
[356] Retention and utilization of export earnings directive, Directive No. FXD/02/1996[Herein after , FXD/02/1996]
[357] FXD/02/1996, Article 6
[358] FXD/02/1996, Article 5
[359] The retention and utilization of export earnings and inward remittances, directive, No. FXD/04/1996[Herein after , FXD/04/1996]
[360] The Retention and Utilization of Export Earnings and Inward Remittances Directives No. FXD/11/1998 National Bank of Ethiopia, 31 August 1998 [Herein after, FXD/11/1998]
[361] FXD/04/1996, Article 5(1)
[362] FXD 04/1996 ,Article 7(1)
[363] FXD 04/1996, Article 8(1)

FXD/11/1998, allows 10% of the foreign currency export earnings to be deposited in forex retention Account A of an eligible exporter. The utilization of the balance on this account shall have no time limit and may be debited with export business-related payments only. The remaining balance, 90%, of the foreign currency earning form export shall be deposited in forex retention Account B of an eligible exporter.[364] The balance in this account shall be offered for sale by the account holder not later than 29 days from date of entry to commercial banks at negotiated rate. Thus, after the expiry of the 28 days, commercial banks are obliged to convert balances on Account B for their own account and pay the Birr equivalent to such customers, using the NBE's marginal rate for that week, which is 2% between the buying and selling rate of banks.[365] However exporters were complaining the above directives saying that the foreign currency proceeded from their export is fully controlled by the government. Some firms revealed that they are not motivated to continue in export market and rather they prefer to sell their products to the local market [366]

In order to solve the problem, the NBE again amends the directive and come up with a more incentivize directive. [367] Unlike the previous one, the exporter can deposit 30% of the export proceeds in Account A for indefinite period of time. And in Account B, 70% of the proceeds will be deposited for up to 28 days. After 28 days, any balance shall automatically be converted in the next working day by customer's bank using the prevailing exchange rate.[368] However Account A and B shall be used to finance related business like currency payments for imports of inputs for their export.

This incentive has a great role in encouraging export sector. However the exporters abuse the balances in retention accounts in spending for other purposes unrelated with the export sector.[369]

4.1.2.4.4 Access to subsidized Credit

There are two types of export incentives in this regard; Export Credit Guarantee (ECG) and availability of subsidized credit. Government has provided this incentive scheme to exporters

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364 FXD 11/1998, Article 6
365 FXD11/1998, Article 6.2
366 Mulu Gebreyesus and Ashagrie Demile, *Why export promotion efforts failed to deliver?* P 22
367 Directive NO FXD 48/2017 Directive for amendment of retention and utilization of export earnings and inward remittances; Directive No fxd 11/1998
368 FXD 48/2017Article 5(1)
369 Interview with Ato Betre Mekonnen, Consumer service officer in commercial bank of Ethiopia, mehetema ghandi branch, May 26/2018

since 2004 in order to provide local exporters' access to bank credit. The scheme allows financing banks to approve pre-shipment or post-shipment credit to exporters upon fulfillment of the eligibility criteria set by NBE and their own normal credit risk analysis. [370]

According to NBE's directive, Directive No. SBB/41/2007, ECG is provided for a year and the criteria to be eligible for the scheme are different for new exporters and existing exporters. New exporters, those engaged in export business for less than 12 months at time of applying, shall produce a collateral equivalent to at least 40% to 50% of the amount of the loan requested.[371] Existing exporters shall produce documentary evidence about receipt of export proceeds in the 12 months preceding the date of application for export loan under ECG scheme. Upon the request of a financing bank, the Guarantor shall issue export credit guarantee to cover 80% of the outstanding loan balance for existing and interest thereof extended to an exporter by the financing bank, provided the request is acceptable to the Guarantor. [372]. All exporters, except coffee, can use this scheme. The Guarantor shall cover 80 percent of the risk, which may result from default of repayment and the financing bank shall bear the remaining portion (20 percent) of default risk.[373]

The second export incentive under this heading is the provision of subsidized credit. Development bank of Ethiopia (DBE) had long been providing development finance to priority sector areas at lower interest rate, 8.5%, which remained fixed even in the period of high inflation. Until recently this incentive scheme had not differentiated those producers for export and local market. The credit policy simply favored priority areas which are believed to be export oriented and strategic import substitutes. Credit was allocated on first come first serve basis and the policy allowed low interest rate for priority areas indiscriminately. [374] In this context the policy failed to meet its objectives of encouraging the export sector.[375]

[370] Preamble of SBB/41/2007 Directive ,Directives to Transfer Duties and Responsibilities Related to Establishment and Operation of Export Credit Guarantee Scheme from the National Bank of Ethiopia to Development Bank of Ethiopia[Herein after, SBB/41/2007]

[371] SBB/41/2007 ,Article 2

[372] *Ibid*

[373] SBB/41/2007,Article 8

[374] Mulu Gebreyesus and Ashagrie Demile,: *Why export promotion efforts failed to deliver?* p 19

[375] *Ibid*

Moreover private firms also suggest that the credit appraisal process has to be short and transparent. According to some firms, they are required to submit 15 documents and the average waiting days to get the final decision for their credit application is more than three months.[376]

4.1.2.4.5. Income Tax Exemptions

Ethiopia provides up to six years of income tax exemption for investment in priority areas[377] irrespective of export or local market orientation. The recent Regulation on Investment Incentives and Areas Reserved for Domestic Investors, Regulation No. 270/2012[378] allows exporters in general to be exempted from the payment of income tax received from exports for additional two years.[379]

According to Regulation No. 312/2014 [380]which amended Proclamation No. 270/2012, an exporter who is located in the industrial zones (IZs) of Addis Ababa or special zones of Oromia and exports 80% of the manufacturing output or supplies the same as an input to export producer will get additional two years income tax exemption. If the exporter is located outside these areas the additional income tax exemption will be up to four years.[381]

One major limitation of this incentive is that exporters receive only two years of additional income tax exemption. It is not enough to motivate firms engage in exports as they can claim income tax exemption for the first six years under the investment incentive scheme.

Another problem is related to the administration of the income tax incentive due to capacity limitation and lack of awareness of exporter on rules and regulations related to the incentives.

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[376] Mulu Gebreyesus and Ashagrie Demile,: *Why export promotion efforts failed to deliver?* p 23

[377]See Mulu Gebreyesus and Ashagrie Demile,: *Why export promotion efforts failed to deliver?* P1
Ethiopia has long recognized the role of export for economic growth and development. In 1992 the country established an Export Promotion Council (EPC) led by the Prime Minister. It also adopted, in 1998, an export promotion strategy, which led to the establishment of the Ethiopian Export Promotion Agency (EEPA). The export promotion strategy was latter transformed into a comprehensive Industrial Development Strategy (IDS) in 2002. The IDS identifies export oriented sectors such as, among others, Textiles and Garment; and Leather and Leather products as priority sectors and aims at increasing the value and volume of export these sectors. This strategy was put into action in the subsequent five years development plans, which carry explicit export targets. Various export incentives and capacity building programs have been devised and implemented to encourage exports in these sectors.

[378]Investment incentives and Investment areas reserved for domestic investors, Council of ministers regulation /2012,Federa Negarit Gazetta ,regulation No 270 ,19th year No 4[Herein after, regulation 270/2012]

[379] Article 7 of regulation 270 /2012

[380] Council of Ministers regulation to amend Investment Incentives and Investment Areas Reserved for Domestic Investors, Council of Ministers regulation/2014, Federa Negarit Gazetta, regulation No 312,20th year no 62 [Herein after, Regulation No,312/2014

[381] Article 3(2) of Regulation No,312/2014

Similar to the other incentives above, the lack of skilled and motivated staff is hindering the efficient implementation of the income tax exemption. ERCA has faced a huge staff turnover. As a result, most of its staffs are fresh university graduates and most of them do not stay for more than two years. The ICT infrastructure is not also well developed, which is even more severe when it comes to branches outside Addis Ababa. In addition, it is not clear as to how ERCA can confirm the beneficiary of the scheme has actually exported 80% of the total production of the year in which tax exemption is requested. This raises the issue of coordination and monitoring problem.[382]

4.1.2.4. 6. External financing and supplier's credit from abroad

External financing and supplier's credit from abroad is another export incentive scheme whereby exports are allowed foreign exchange access. According to NBE's directive No. REL/005/2002,[383] applicants for the registration of external loans and suppliers or foreign partners' credit or other implicit form of foreign credit, should be individuals or firms engaged in export oriented activities.

The application for the schemes should be made using the form designed for the same purpose and submitted to the NBE together with the necessary documents. Borrowers who obtain a credit in the form of suppliers' credit shall produce a contract agreement to NBE which contains terms of payment, interest payment, arbitration procedure, terms of delivery of goods covered and repayment schedule. In this scheme, any exporter is allowed to use the foreign currency to meet expenses of transportation and transit of exportable, and to acquire capital goods, raw materials, semi finished goods, square parts and other such inputs for use in their activities. An eligible borrower shall first get approval from the NBE before entering to external loan and suppliers credit agreement with the lender or supplier.[384]

However the problem with this scheme is that more than 99% of the users of the external loan and suppliers' credit scheme are foreign firms indicating that this scheme has not benefited the

[382] Mulu Gebreyesus and Ashagrie Demile,: *Why export promotion efforts failed to deliver?* p 21

[383] Registration of External Loan and Suppliers or Foreign Partners' Credit, Directive No. REL/005/2002 and now amended by external loan and supplier's directive no 47/2017[Herein after, FXD 47/2017]

[384] FXD 47/2001 Article 3.2

domestically owned firms. The reason for this might be local exporters don't have the collateral that they can offer for foreign financers.[385]

4.1.2.4.7. Franco-Valuta import (Import without using national foreign currency)

Importation of Goods on Franco-Valuta basis is the other export incentive scheme which allows exporters to have access to foreign exchange. According to the revised regulation by the Council of Ministers, Regulation No. 88/2003,[386] foreign and Ethiopian investors permanently residing abroad can import machinery and goods for their investment activities or inputs for the production of export output on Franco Valuate basis.[387] Exporters who want to use this scheme can apply to ERCA either before or after the item to be imported entered into the country. Depending on the nature of the commodity/input imported, exporters might be asked to present evidence of certification about the nature of the commodity from relevant agencies. [388]According to the directive which transferred NBE's foreign exchange functions to Commercial Banks, commercial banks shall allow Franco-Valuta imports subject to the presentation of documents required. But the actual permit to import is given by ERCA.[389]

The role of banks in this case is just to record the import transaction in the banking system and collect the 2% service charge on behalf of NBE. The beneficiaries of the Franco-Valuta scheme are, however, the foreign or diaspora owned firms. Thus, this incentive has no relevance to the local owned firms similar to the external financing and supplier credit scheme discussed above.[390]

External financing, supplier credit, and Franco Valuta imports are aimed at increasing the foreign exchange access of exporters. Nonetheless, more than 99% of the users of external financing and supplier credit schemes are foreign firms. The reason might be local exporters do not have the

[385] Mulu Gebreyesus and Ashagrie Demile,: *Why export promotion efforts failed to deliver?* p 23

[386] The revised regulation on the import of goods on Franco valuta basis, Council of Ministers regulation/2003, Federa Negarit Gazetta, regulation No 88,9th year no 81[Herein after, regulation 88/2003]

[387] Regulation 88/2003, Article 2(9), Goods imported for investment activities including capital goods and raw material adequate up to commissioning stage and for their personal use by Ethiopian and foreign nationals of Ethiopian origin investors who are permanently residing abroad and having license from the appropriate government office.

[388]Mulu Gebreyesus and Ashagrie Demile,: *Why export promotion efforts failed to deliver?* p 24

[389] Directive to transfer NBE's Foreign Exchange Functions to Commercial Banks, Directive No. FXD/07/1998 [Herein after , FXD/07/1998]

[390] Mulu Gebreyesus and Ashagrie Demile,: *Why export promotion efforts failed to deliver ?* p 24

collateral that they can offer for foreign financers. Similarly, the franco-valuta is given only for foreigners and Diaspora. Thus, they have no effect on the local exporters' motivation.[391]

4.1.2.5. Monitoring under invoicing

The government of Ethiopia keeps endeavoring to avoid the parallel market in the country. The new directive, fxd no 52/2017 [392]and its amendment directive no 53/2018[393] is the other policy measure to combat the parallel market.

The necessity for the enactment of these directives is to monitor under invoicing of some import items and take preventive measures against those who attempts to be involved in such mal practice by setting minimum price for selected import items.[394] Though not found explicitly, the intention of NBE behind these directives is to halt the business of Illegal parallel market in the country[395].

The National Bank of Ethiopia (NBE) amended the 'Setting of Indicative Minimum Price for Selected Import Items' directive issued to tackle under invoicing and the illegal forex market. The Directive FXD/52/2017 was applied at the beginning of December 2017 to force hard currency buyers, particularly importers and to access a LC equivalent to the price of the selected imported items. It was calculated using the price valuation that the Ethiopian Revenue and customs Authority (ERCA) uses to calculate customs duty. An amendment to the FXD/52/2017 directive called FXD/53/2018 has become effective as of the March 15.[396]

According to the new directive, banks are authorized to check and approve the price of items. Previously this was the responsibility of NBE under the amended directive fxd 52/2017.

[391] Mulu Gebreyesus and Ashagrie Demile,: *Why export promotion efforts failed to deliver ?* p P 26
[392] Directive No, 52/2017 on setting of indicative minimum price for selected import items[Herein after, FXD 52/2017]
[393] Directive No 53/2018, Amendment to Fxd 52/2017 on setting of indicative minimum price for selected import items[Herein after, FXD 53/2018]
[394] Preamble of FXD 53/2018
[395] Interview with Economist Zemzem Mohammed, officer in the economic sector research department in NBE, April 7/2018
[396] Muluken yewondessen, 'NBE allows banks to check and approve price of imported items', online, *capital News,* http://capitalethiopia.com/2018/03/26/nbe-allows-banks-check-approve-price-imported-items/ (last accessed May 3/2018)

[397]Customers had previously complained that people were supposed to get a NBE approval by obtaining a LC from the banks. NBE provided an approval for the price of items that are not found as stated items on the directive. The system created crowded conditions at the central bank forcing NBE to give the role to banks.[398]

The amendment directive no 53/2018 amended the previous directive which indicated that a National bank is authorized to process import items if the price of the item is not found as stated under article 3.3, which shows the items that are included under the Harmonized System of Commodity Description, of these directives. The directive has also attached a letter format that has to be filled for such kind of process. The banks are also authorized to undertake the performing invoice on their own, but they are obliged to report with relevant documents to NBE every week.[399]

Due to the directive, importers have to open an equivalent letter of credit (LC) as per the given price that NBE distributed to banks for selected items. In the past importers may access a small amount from banks other than the exact volume of imported items. They have been using the hard currency from other sources like illegal remittances or the parallel market.[400]

However some of the importers like investors that are engaged in different investments mainly on the export sector are complaining about the new scheme. They claim that the directive does not take their activity into account. They argue that the hard currency shortage in the country forces hard currency buyers to wait for several months to obtain the needed amount. They say the new directive affects this and insist relevant government bodies lift the directive implementation in their operation.[401] Experts said that some of the importers are using the imported items as an input for their production in the factory or farms as opposed to selling them.

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[397] FXD 52/2017, Article 4

[398] Muluken yewondessen, 'NBE allows banks to check and approve price of imported items', online, *capital News,* http://capitalethiopia.com/2018/03/26/nbe-allows-banks-check-approve-price-imported-items/ (last accessed May 3/2018)

[399] FXD 53/2018, Article 4.3 and 5

[400] Interview with Ato Abebayehu rufira, officer in the external sector research department, April 15/2018

[401] Muluken yewondessen, 'NBE allows banks to check and approve price of imported items', online, *capital News,* http://capitalethiopia.com/2018/03/26/nbe-allows-banks-check-approve-price-imported-items/ (last accessed May 3/2018)

They claim that the government should consider excluding such kind of importers from the new directive. [402]

On the other hand importers also claimed that the directive does not consider the discounts given by suppliers against the minimum indicative price of NBE when they order bulk purchases.[403] Under invoice issue has been a problem for the country and it has also contributed for the country to be criticized by others as a place where people launder money and a hub of illegal money transfers.[404]

Besides that, the tax, duty and other issues have been directly related with the issue. Previously a car importer would open a LC worth USD 1000USD for the import of a car but the actual price of the car is USD 8,000 and the importer may import 10 cars filling the remaining money from illegal market sourced from informal remittance schemes or other sources. The current directive shall alleviate this misbehavior by using a Harmonized System of Commodity Description, an internationally standardized system of names to classify traded products and issued by ERCA.[405]

Other importers are also complaining this directive however. They are saying that "our first priority is to use banks. But there is high restriction in allocating foreign exchange. There is shortage of foreign currency as a result we can't get the needed amount even after waiting more than a year. Having this problem, obliging the importer to import by the drop of foreign currency from the bank is not proper.''[406] The directive may be important in avoiding under invoicing. But applying this directive strictly will halt importation. The government is obliging importers to source foreign currency from banks but banks have no foreign currency to give them, which is illogical. Nowadays it is possible to say that there is no importation as a result the country is losing significant tax revenue from importation.[407]

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[402] Muluken yewondessen, 'NBE allows banks to check and approve price of imported items', online, *capital News,* http://capitalethiopia.com/2018/03/26/nbe-allows-banks-check-approve-price-imported-items/ (last accessed May 3/2018)

[403] Interview with Ato Zeynu Mohammed, importers of different items, April 7/2018

[404] Muluken yewondessen, NBE allows banks to check and approve price of imported items, online, *capital News,* http://capitalethiopia.com/2018/03/26/nbe-allows-banks-check-approve-price-imported-items/ (last accessed May 3/2018) and from Interview with Ato Abebayehu rufira, officer in the external sector research department, April 15/2018

[405] Interview with Ato Abebayehu Rufira, officer in the external sector research department ,April 12/2018

[406] Interview with anonymous importers of different items Merkato, April 13/2018

[407] Interview with Ato Eyob Abreham, Manager of Awash international bank , Merkato branch , March 29 /2018

The other importer who wants to remain anonymous said that the new Directive no 46/2017 doesn't consider the business reality. The directive prohibits supplier and item change.[408] This means that when the importer opens LC, the importer should submit the name or the supplier of the goods whom he/she buys. However until the foreign currency is available, it may take even more than a year. In the mean time, the supplier whose name is submitted before a year may stop selling the specific goods the importer already submitted for Bank or the supplier may be out of business. In this scenario, the directive prohibits changing supplier and as a result the money the bank gives will be without purpose. This prohibition may be possible if the foreign currency is available at any time in the bank. The directive does not consider the reality in the ground. The new directive 53/2018 aggravate the problem of Article 7.10 of FXD 46/2017.Both directives doesn't consider the severe foreign currency shortage in the formal channel. The government doesn't know the business environment and we are really affected by such laws which don't consider the real business environment. [409]

The other defect of the directive as per the manager of Awash international bank is that, the new directive prohibits item change. Once the importer submits the name of the goods he/she wants to import, he/she cannot change later on when the foreign currency is available. The good the importer wants to import at the time of application may not be needed in the market at the time the foreign currency is available. He said that, the bank cannot give foreign currency at the time they request for importation. For instance the fashion of the time may be jeans products but at the time the currency is available, this fashion may be changed and the market may not need it. Having a long delay in the bank to provide hard currency, prohibiting the importer not to change item and suppliers is not proper.[410]

One of the Managers of commercial bank of Ethiopia comment the directive by saying that, the government is just going around the bush leaving the root problem. The problem and the solution are unrelated. The government should control those who suck foreign currency from the country.

[408] FXD 46/2017 Article 7.10 states that, a bank is prohibited to accept request on change of items and suppliers after registration of Performa invoice.]

[409] Interview with anonymous importer working in Merkato, April 15/2018

[410] Interview with Ato Eyob Abreham, Manager of Awash international bank , Merkato branch, March 29/2018

Even though the directive prohibits the importers from using the parallel market, the business man still find a way to evade the new directive too. The new directive is not a solution at all.[411]

The government is focusing on one dimension disregarding the impact it may have. The new directive may overcome under invoicing but it affects Importation. In the country where even consumption goods are imported, putting such prohibition affect the country and government also loss huge tax revenue from importation if the importers are to use a drop of foreign currency from the bank. It is not feasible to apply the directive in the country where most of the products come through importation.[412]

The only intention of NBE in enacting this directive is just to ban the parallel foreign exchange market. However, this directive is not promising as business persons have always a means to make a way unless the attitudes of the importers are changed.[413] There are reports that the directive is not working and importers are still under invoicing through different deceiving activities.[414]

The remittance from abroad is passing through parallel market. Importers are financing their business from outside sources that collect hard currency secured from illegal money transfers. This new directive forces the importer to use only banks for foreign currency. Huge foreign currency is collected abroad by Ethiopians and the Importers buy them for importation. But if we force the importers to use only the formal channel by this directive, the remittance which is passing through informal channel in order to finance importation will be stop. In doing so, the directive will serve many purposes. First it secure remittance from Ethiopian abroad to pass through formal channel, second It minimize the parallel forex market and finally it decrease the foreign currency shortage in the country. This is the intention and the purpose of the directive.[415] However the researcher is in the opinion that the new directive is encouraging the importers to dig another way out. The problem can't be solved by tightening the control again which is the cause for the emergence of parallel foreign exchange Market in Ethiopia and in many countries in the world.

[411] Interview with Anonymous manager of Commercial bank of Ethiopia ,April 16/2018
[412] Interview with Ato Eyob Abreham, Manager of Awash international bank , Merkato branch , March 29/2018
[413] Interview with Zemzem Mohammed, officer in the economic sector research department in NBE, April 7/2018
[414] Interview with Zelalem Getnet, officer in the external sector researcher department in NBE, May 25/2018
[415] Interview with Ato Abebayehu Rufira, officer in the external sector research department in NBE, April 12/2018

The new directive of NBE doesn't consider the economic situations in Ethiopia. The simple logic is, the bank can't give the needed foreign currency for importers. As a result the importers stop importing as the new directive prohibits alternative means of getting foreign currency. The writer is in the opinion that the government is not addressing the root problem. The existence of the parallel market is the result of foreign exchange control which is again the result of foreign currency shortage. Identifying the cause may lead to the solution. The cause of the parallel market is strict foreign exchange control then the solution is making the foreign exchange control less restrictive not tightening it again.

Controls cannot substitute for macroeconomic and structural adjustments that are needed. There is substantial experience to show that the effectiveness of controls diminishes over time, in particular when needed policy adjustments are not addressed. The less appropriate the overall policy package, the greater the leakage into the parallel foreign exchange regime. Sound economic and monetary policy which considers the root problem is a need. [416]The policy regimes which the researcher discussed so far fall to shut down the illegal parallel market and the country is facing the problem despite different policy measures taken by the government.

4.2 Absorbing the parallel foreign exchange market in to the formal market

There are two choices that come to once mind thinking the parallel market in Ethiopia. Either the government have to make accessible the demanded foreign currency which is infeasible for many reasons or allow alternative means of getting foreign currency for the people having supervision role to control illicit activities like money laundering and terrorism financing. This is exactly different countries including Ghana[417], Uganda[418] and Malawi [419]did. Without providing

[416] Leonides Buencamino and Sergei Gorbunov, *Informal Money Transfer Systems: Opportunities and Challenges for Development Financ*e, DESA, Discussions on Economic and social affairs, Paper No. 26, November 2002 United Nations, p 9 [Herein after , *Leonides Buencamino and Sergei Gorbunov, Informal Money Transfer Systems*]

[417] The Parallel market in Ghana was legalized in January 1988. The first bureau started operations on April 8, and by the end of 1988 over 70 bureaux had been established and over 180 were fully licensed by the early 1990s (Harrigan and Oduro, 2000). See Aliyu Rafindi, Sanusi, Lessons from the foreign exchange market reforms in Ghana, 1983-2006, Ahmed Bello University, Nigeria, 2010, *Journal of Economics and Allied Fields, Vol. IV No. 2,* p 9[Herein after, Aliyu Rafindi, Sanusi, Lessons from the foreign exchange market reforms in Ghana, 1983-2006,

[418] Uganda's Forex act of 2014 legalize and licenses parallel forex market dealers provided that they fulfill the requirements in the act.

[419] The foreign exchange bureaus were granted permission to operate from the mid 1990s to incorporate a parallel market into the legal foreign exchange system in Malawi. Operators in the bureaux de change are private entrepreneurs who have been formally recognized by the government to deal in foreign exchange and provide access

the needed amount of foreign currency at the time required, prohibiting the alternative means is illogical and that is why this measure fails for more than four decades since the Derg regime.[420]

Parallel markets are widely tolerated in developing countries [421]while some of them legalize them through licensing. The typical argument used to justify them is that governments realized that as long there is demand rationing in the official market for foreign exchange, there is bound to be a secondary market. [422]Mc Dermott (1989) puts forward another interesting argument that may help explain why authorities tend to accommodate rather than confront parallel markets. He suggests that the existence of a parallel currency markets may yield two types of benefits. First it increases employment by raising the domestic availability of imported inputs. Second it may actually increase the flow of foreign currency to the central bank in that when the increased availability of imported inputs allows total exports to expand and to expand so much that foreign currency receipts increase through both legal and illegal channel. [423]The demand for foreign currency to finance legal imports stems from the existence of rationing in the official market for foreign exchange.[424] As foreign exchange control lead to the emergence of parallel currency markets, they also affect private agents' economic decision notably the decision to evade restrictions by purchasing foreign currency illegally in the parallel market. A parallel markets in foreign currency is taken to be socially desirable because the parallel markets meets the demand of operations rationed in the official market.[425]

In Ethiopia the excess demand of foreign currency is being satisfied by the parallel market. Though the way is informal, their role is great in the economy. Importation is being financed by the parallel market, payments for different affairs are sourced from the[426] parallel market because

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to foreign exchange in a convenient and informal manner .see Nills Maehle, *et al* ,*Exchange rate liberalization in selected sub Saharan African countries ; success , failures and lessons* ; IMF working paper , January 2013,p22

[420] Tefera lemma, *determinants of parallel foreign exchange market in Ethiopia*, p 30

[421] Pierre- Richard Agenor , *Parallel currency markets in developing countries*: p 12

[422] See Pierre- Richard Agenor , *Parallel currency markets in developing countries:* p 12 and Perre Richard Agenor and Nadeem U.Haqu, *Macroeconomic management with informal financial market* , p 90

[423] Pierre- Richard Agenor , *Parallel currency markets in developing countries*, p 13

[424] *Id* p 10

[425] *Id* p 11

[426] In Ghana also importation was being financed by the parallel market. After they have been licensed, the bureaus were allowed to fund all legal imports and services. See Aliyu Rafindi, Sanusi, Lessons from the foreign exchange

of tight procedures and delay in the formal market. As discussed in chapter two of this paper, importers who face constraints in foreign exchange rationing may smuggle out the hard currency they collected or they may assign agents in foreign countries to collect and bulk hard currencies for them. In both cases importers spend the money they bulked on purchasing goods and services that will eventually enters Ethiopia and support the economy though it passes illegally.[427] Parallel market users are not importing heroine or weeds or other dangerous materials unlike other countries. The market is important in financing legal importation .Rather the problem the government is encountering as a result of the parallel market is government loses control on foreign exchange allocation. The parallel market users are mostly importing cars but had the foreign currency available in the parallel market is in NBE, it would have been used for establishing factories and other important investment areas.[428] The parallel market is supporting the economy though informally.

Thousands of people who have to travel abroad for medical treatment, education, trade fairs, holiday or other small scale business financed through parallel market.[429] Everyday thousands of people leave the country to Europe, US, Africa, India, China or any other countries for business or pleasure. So they have to get dollar from the National Bank or the parallel-market. Say, if the National Bank rations 500 dollars per travel per person one can easily multiply it by at list 1000 people leaving the country. That means the National Bank is expected to handover at list 500,000 dollars per day for travelers or tells them to stay at home. Where the National Bank is going to get this money? The choice is either the people have to stop flying or they have to go in to underground to buy dollar at much higher price.

The issue here is, is that necessary to take them off the right to get license for their transaction?

Given the importance of parallel market, actions in this area should not aim to ban these systems or limit their accessibility. Such an approach had been attempted in several developing countries.

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market reforms in Ghana, 1983-2006, 2010, *Journal of Economics and Allied Fields, Vol. IV No. 2,* p 9[Herein after, Aliyu Rafindi, Sanusi, Lessons from the foreign exchange market reforms in Ghana, 1983-2006]

[427] Interview with Ato Abebayehu Rufera and Zelalem Getnet, officers in the external sector research department in NBE, May 25/2018
[428] *Ibid*
[429] http://ethiofact.com/3461/black-market-or-open-air-market-money-changers/ (last accessed in March 28/2018)

But it did not achieve its intended goals and only harmed law-abiding people and served to drive informal money transfer operations further underground. The introduction of exchange controls tends to promote a culture of law evasion among private entrepreneurs that may spill over into other areas such as tax compliance or adherence to other economic and financial regulations.[430]

It is unlikely that efforts to shut down parallel markets would succeed. Whatever happens, there will still be a huge demand for informal methods of money transfer and it is better that such services remain in the open. Otherwise, informal systems could become more prone to engaging in other illegal activities as part of or in parallel with their money transfer operations.[431]

For example, the threat of enforcement and penality was significant in Ghana before 1983, but these efforts fell later on, and the coverage of the parallel market grew, as did the parallel premium.[432] In Sudan, trading on the parallel market was a capital offense, and enforcement was attempted between 1970 and 1990. But even the threat of capital punishment did not totally wipe out the parallel market, though it may have been a factor in the very high premium observed in Sudan.[433]

The fear that parallel market creates capital flight, money laundering, loss of control on the foreign exchange etc can be solved not by curtailing them but by regulating them. A more open foreign exchange regime would likely translate into a reduced need for foreign currency to be smuggled into the country.[434]Regulating them increase the level of transparency of business and enable to bring overall business activity within the scope of all the regulatory requirements. It is only when they are regulated that the government can apply anti-money laundering legislation and other related legislations. In doing so the government can traces all activities of parallel market dealers.[435] Accordingly, the purpose of any measure related to parallel market should be

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[430] Nita Ghei and Steven B.kamin , the *use of the parallel market rate as a guide to setting the official exchange rate* p,504

[431] Leonides Buencamino and Sergei Gorbunov, *Informal Money Transfer Systems* , P 12

[432] Miguel A. Kiguel, Stephen A.O'connell; *Parallel exchange rates in developing countries*; Lessons *from eight case studies* , the world bank policy research department ,policy research working paper 1265, March 1994 as cited by Nita Ghei and Steven B.kamin *, the use of the parallel market rate as a guide to setting the official exchange rate* p 500-501

[433] Nita Ghei and Steven B.kamin *, the use of the parallel market rate as a guide to setting the official exchange rate* p 500-501

[434]Tom Kiantige, *Growing an Economy*, p3

[435] Leonides Buencamino and Sergei Gorbunov, *Informal Money Transfer Systems* , P 12, In Canada, the Netherlands, United Kingdom, and United States, the law requires financial institutions, including IMTS, to

the regulation. Though cost effectiveness and quickness of their service are virtues under any circumstances, lack of transparency and accountability as well as absence of government supervision raises the possibility of abuse by criminals. [436] The inherent confidentiality of transactions in the parallel market and absence of legal accountability for anyone operating in the parallel market provides incentive to use the parallel market for concealing illegal activities.[437] Traceability may be one advantage of regulating the parallel market in Ethiopia.[438]

Licensed intermediaries can assist the central bank in enforcing regulations**.** Often; they can only make a currency exchange once they have verified that the underlying transaction is legally permitted. They must comply and verify compliance with regulations involving the use and exchange of foreign currencies, including reporting requirements, prudential regulations on net open positions, capital controls, and anti-money-laundering and anti-fraud legislation, among others.[439]Most developing countries license dealers and many countries also license voice brokers as foreign exchange intermediaries. In some countries, the intermediaries include foreign owned institutions.[440]

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maintain records of their customers and their transactions. In Germany and the United States, a license is needed to engage in the business of money transfer. Licensing, record keeping and reporting requirements are applied to IMTS in Singapore, Taiwan Province of China and Hong Kong, China. Under newly proposed regulations, Pakistan would establish regulated currency-exchange companies. After these companies are formed, individual money changers would have to link themselves to one of these companies and accept all the regulatory requirements. And, according to the central bank, the United Arab Emirates will set up licensing and supervision system for informal money transfers by the end of July 2002. See Leonides Buencamino and Sergei Gorbunov, *Informal Money Transfer Systems*

[436] Leonides Buencamino and Sergei Gorbunov, *Informal Money Transfer Systems* , P 12, At an extraordinary meeting held in Washington, D.C. on 29 and 30 October 2001, the Financial Action Task Force (FATF) agreed to a set of Special Recommendations on Terrorist Financing. One of these recommendations commits members to take measures to ensure that persons or legal entities that provide a service for the transmission of money, including transmission through an informal money transfer system or network, should be licensed or registered and subject to all the FATF anti-money laundering requirements that apply to banks and non-bank financial institutions.

[437] Pierre- Richard Agenor , *Parallel currency markets in developing countries*, p 10

[438] Interview with Ato Tibebu H/Ghiorgis, Vice-Director of Foreign Exchange Monitoring and Reserve Management Directorate of NBE, April 15/2018

[439] Jorge Iván Canales-Kriljenko*,Foreign Exchange Market Organization in Selected Developing and Transition Economies: Evidence from a Survey*, IMF Working Paper, January 2004,p 15 [Herein after, Jorge Iván Canales-Kriljenko, *Foreign Exchange Market Organization in Selected Developing and Transition]* Economies:]

[440] *Id.,* p 19, A few countries allow dealers to buy and sell foreign exchange but only on behalf of the central bank. This gives the central bank a central role in foreign exchange intermediation. These regulations are sometimes supported by surrender requirements directed to the central bank. See Jorge Iván Canales-Kriljenko, *Foreign Exchange Market Organization in Selected Developing and Transition*],

Authorized dealers must report information on a wide array of variables affecting the foreign exchange market. These include data on exchange rates, foreign exchange transaction volumes at different levels of trading, open foreign exchange positions, and domestic currency balances for meeting reserve requirements. The scope of the data requested varies significantly across countries, ranging from all information on each of the foreign exchange transactions made by each authorized dealers to summary statistics, sometimes weighted by the size of the transactions.[441]

Unlike prohibition, the introduction of regulatory measures strikes an important balance between protecting financial and security interests and allowing informal operations to serve legitimate purposes for which they have been designed. In this case the business owner acquires a legal standing that facilitates his operations while the customer is protected by law. On the other hand; non-compliant businesses or those engaged in illegal activities would face sanctions for violating the new legal requirements, potentially limiting their customer use.[442]

The 1977 Foreign Exchange Control Regulation[443] Regulation No.1/1977which was issued under the Dergue regime was one of the most comprehensive legal frameworks that laid down Foreign Exchange Control Regime of Ethiopia and its major provisions are still applicable. In the regulation the only person to be authorized to engage in foreign exchange transactions are banks. Under Article 2(4) of the regulation, authorized banks are defined as any bank authorized by the National bank to engage in foreign exchange transactions. The regulation clearly excluded any person other than banks to engage in the foreign exchange transactions.

In August 3 1996, commercial banks were allowed to establish foreign exchange Bureaus under Directives No.FXD/01/1996.[444] This directive legally recognized Authorized Commercial Banks to engage in the transaction of buying and selling foreign exchange from and to the public through a unit called " A foreign exchange bureau" or forex bureau".[445] It defines Authorized commercial banks as any bank established in accordance with the law and issued authorization

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[441]Jorge Iván Canales-Kriljenko, *Foreign Exchange Market Organization in Selected Developing and Transition* ,p 21

[442]Leonides Buencamino and Sergei Gorbunov, *Informal Money Transfer Systems*: p 12-13

[443] Regulation No.01/1977

[444]Directive on Operation of Foreign Exchange Bureau, National Bank of Ethiopia, Directive No. FXD/01/1996, 3 August 1993[Here in after.FXD/01/1996]

[445] .FXD/01/1996, Article 19(d)

certificate by the bank. Authorization certificate also mean a document issued to a commercial bank by the national bank evidencing the former's compliance with the conditions necessary to open a forex bureau. [446]

The conditions or the requirements to get authorization are listed under Article 21 and 22 of the directive. [447]As we can see, all the previous directives keep themselves away from authorizing other persons than banks to engage in foreign exchange transactions.

Astonishingly, however, Proclamation No. 591/2008 shows the possibility that other person, juridical or natural person, than commercial banks can engage in a business of buying and selling foreign exchange with prior authorization of NBE.[448] Article 20(1) of proclamation no 591/2008 states that "No person shall engage in any transaction of foreign exchange except with banks or authorized dealers or with the special permission of the National Bank."

Article 2(1) defines "authorized dealer" as "*any person other than a bank, which is authorized by the National Bank to engage in foreign exchange transactions.*" Any such person is referred as "authorized dealer" according to the proclamation.

Hence, "authorized dealer" doesn't refer forex bureau of commercial banks. However, unlike forex bureau of banks, law or directives of NBE do not yet determine the conditions and requirements for authorizing those dealers. It is not also clear whether the requirements of commercial banks are equally applicable to authorized dealers. Practically it is controversial whether NBE actually authorizes other dealer than banks to engage in business of buying and selling foreign exchange in Ethiopia. The Interview with NBE officials reveals that so far NBE only authorizes commercial banks to engage in foreign exchange transactions.[449] On the other hand, one of the officer opined that as per Directive No.FXD/42/2013 some hotels, duty-free shops, tour operators, Immigration Office and Civil Aviation Authority are authorized by NBE to

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[446] FXD/01/1996, Article 19(a) and (b)

[447] The conditions are a) have a premise(s) suitable in all respects to carry on the business of a forex bureau and that meets safety and security standard set by the Bank; b) have the necessary device/equipment to detect counterfeit notes; d) provide list of names and designations of the forex bureau staff; and e) ensure that Head and staff of the forex bureau are people of integrity, credibility and competence, with no record of fraud and embezzlement. Security requirement requiring a forex business shall be situated in a secure place of business separate but accessible to consumers, computerized forex bureaus.

[448] See Proclamation No. 591/2008, Article 2(1) & Article 22(5(a))

[449] Interview with Ato Tibebu H/Ghiorgis, Vice-Director of Foreign Exchange Monitoring and Reserve Management Directorate of NBE, April 15/2018

receive payments in foreign currency and they might be considered as "authorized dealer though there is limitation in their transaction".[450] However, those hotels and duty-free shops hardly fulfill the definition of "authorized dealer" since they are at the same time required to convert all foreign currencies collected during one business day at forex bureaus within two working days.[451] Moreover, they are not authorized to sell foreign exchanges. Therefore, it is difficult to consider them as authorized dealers.[452]

The NBE should make use of provisions of law on authorized dealers by authorizing or licensing other person as "authorized dealer" to minimize the parallel market in Addis Ababa by accommodating them within the formal and legal framework. This was one of the measures that have been taken by Foreign Exchange Act of Uganda which empowers Central Bank of Uganda to issue a license to any person to engage in the business of dealing in foreign exchange.[453]

Under the Foreign Exchange Act, 2004 of Uganda, any person can engage in the business of dealing in foreign exchange having license from the National bank of Uganda. Like Ethiopia's directives no 591/2008, the Uganda's foreign exchange act 2004 stipulates that only licensed or authorized can engage in the foreign currency transactions. But unlike Ethiopia's establishment proclamation no 591/2008, the Uganda's foreign exchange act 2004 states the requirements that must be fulfilled in order to be authorized or licensed to engage in the foreign exchange transactions. For instance it states, status of person, the minimum paid up share capital, the required fee for license, the term of the license, the renewal procedure, the form of the corporate, duration, extension, reasons for revocation of license as well as right of Appeal.[454]

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[450] Interview with Ato Zelalem Getnet, officer in the external sector research department in NBE, May 25/2018

[451] .FXD/42/2013, Article 4.5.4

[452] Eyader Teshome, *Legal and regulatory issues of Ethiopia's foreign exchange regime and transactions* , p 75

[453] Foreign Exchange Act of Uganda 2004 , Act 5, *The Uganda Gazette* No. 64 Volume XCVII dated 3rd December, 2004., Article 5(2)

[454] Article **5. Licensing.** (1) Except as permitted by any other law, no person shall engage in the business of dealing in foreign exchange without a license issued under this Act.
(2) The Bank of Uganda may, for a fee of fifty currency points, issue a license under this Act to any person to engage in the business of dealing in foreign exchange. (3) The minimum paid up share capital to carry out the business of dealing in foreign exchange shall be one thousand currency points. (4) The minimum paid up share capital for a person to carry out the business of money transfers shall be two thousand five hundred currency points. (5) The Bank of Uganda may issue or renew a license issued under subsection (2) to a person to engage in the business of buying and selling bank notes, coins and traveler's cheques in foreign currency or such activities as may be specified by the Bank of Uganda. (6) A license issued or renewed under this section shall expire one year after the date of issue unless the license has been renewed, extended, or revoked by the Bank of Uganda. (7) In considering an application for the renewal of a license, the Bank of Uganda may, subject to such conditions or

This law clearly sets the condition, and requirements to engage in foreign exchange dealing.[455] For instance, only a body incorporated under the Companies Act or under any other Act is qualified to be issued a license.[456]

Because of the continued co-existence of the parallel market, the Parallel market in Ghana was legalized in January 1988. This, along with the subsequent licensing of parallel market in February 1988, marks a key step in the effort towards the liberalization and stabilization of the exchange rate market.[457] The key objective of institutionalizing the bureau de change was to eliminate the parallel market, and absorb the parallel market into one single foreign exchange market (Dordunoo, 1994). The first bureau started operations on April 8, and by the end of 1988 over 70 bureau had been established and over 180 were fully licensed by the early 1990s (Harrigan and Oduro, 2000). The bureaus were allowed to be owned and operated as separate entities by banks, institutions, Individuals, or groups provided that they had the license. [458]

The bureaus were allowed to fund all legal imports and services. They could buy and sell foreign exchange at a freely negotiated rate and no requirements were made on them to indicate or identify their sources of foreign exchange or customers. The only two requirements were for them to (1) report to the Bank of Ghana (BoG) on a monthly basis the volume of purchases and sale and the type of currencies involved, and; (2) not buy travelers cheques in other currencies than British pounds and American dollars. Also, the currencies they were allowed to buy

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restrictions as the Bank of Uganda considers appropriate, extend the period of application of the license holder's existing license for a period not more than three months so as to permit the license holder to take such action as the Bank of Uganda considers necessary to enable the license holder to comply with this Act and the regulations, permissions, instructions and directions issued under this Act.
(8) When issuing or renewing a license under this section, the Bank of Uganda may impose upon the license such conditions or restrictions as the Bank of Uganda considers appropriate.
(9) Only a body incorporated under the Companies Act or under any other Act shall qualify to be issued a license under this section.
6. Suspension and revocation of license**.**
(1) The Bank of Uganda may revoke or suspend a license, if it has reasonable cause to believe that the license holder has infringed the provisions of this Act or any regulations made under this Act.

[455] *Id*. Article 5, 6 and 7
[456] *Ibid*
[457] Aliyu Rafindi, Sanusi, 'Lessons from the foreign exchange market reforms in Ghana, 1983-2006', *Journal of Economics and Allied Fields, 2010, Vol. IV No. 2, ,*pp 1-19, at p 3, [Herein after, Aliyu Rafindi, Sanusi, Lessons from the foreign exchange market reforms in Ghana, 1983-2006]
[458] *Id* p 9

included the Canadian dollar, US dollars, UK pounds, CFA and French francs, and Deutsche marks.[459]

The main sources of foreign exchange supply for the bureau were the exporters' retention accounts, receipts from unofficial (illegal) exports, non-traditional exports, and private remittances. Their main sources of demand for foreign exchange include all legal (and indeed illegal) imports, service payments and capital transaction.[460]

Ethiopia needs to take a lesson from the above experiences by not merely indicating the possibility that other person may engage in foreign exchange transactions, but the law must set the condition and requirements one supposed to fulfill to operate such business.[461]

The logical and obvious implication is that if parallel markets emerge in response to the imposition of controls, the most effective remedy is to eliminate the restrictions.[462] The existing control could not stop the parallel market operators from participating in illicit trade and capital flight. This can be witnessed by the very existence of the market together with excessive control, i.e. during the Derge regime.[463] Parallel market is not something that can be avoided by strong control and monitoring. For the strong control no one can be compared with the Derg regime. But the market still persists even more than ever. The only solution is boosting export. Increasing the proceeds of exportation through different incentive mechanism is the only solution to the problem of parallel market.[464] Parallel exchange market continues to exist in a significant number of developing countries around the world.[465]

The currency black market flourished in Ghana until the financial market was liberalized in 1988 to allow the operation of forex bureaus. Before then, the black market was the only alternative to the more restrictive foreign exchange system operated by the traditional banks.[466] The official exchange rate was so overvalued by the end of the 1980s that it became irrelevant for most

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[459] Aliyu Rafindi, Sanusi, Lessons from the foreign exchange market reforms in Ghana, 1983-2006,p 3
[460] *Ibid*
[461] Eyader Teshome, *Legal and regulatory issues of Ethiopian foreign exchange regime and transactions*, p 75
[462] Pierre- Richard Agenor , *Parallel currency markets in developing countries*, p 18

[463] Tefera lemma, *determinants of parallel foreign exchange market in Ethiopia*, P 30
[464] [464] Interview with Ato Tibebu H/Ghiorgis, Vice-Director of Foreign Exchange Monitoring and Reserve Management Directorate of NBE, April 15/2018
[465] Nita Ghei and Steven B.kamin , *the use of the parallel market rate as a guide to setting the official exchange rate*, p 505
[466] https://www.graphic.com.gh/features/opinion/the-booming-black-market-foreign-exchange-business-in-accra.htm (last accessed May 14/2018)

transactions and even domestic prices and inflation reflected the parallel, not the official rate.[467] Section 29 of the Foreign Exchange Act, 2006, noted that it is a crime to deal in foreign exchange without a license in the country. Operators in forex trade are also required to computerize their operations through the adoption of certified software approved by central Bank according to the 2014 Bank of Ghana (BoG) regulations. The regulations required operators to keep electronic records of all purchases and sales that will include the name of the customer, the date of transaction, the amount purchased or sold and proof of identity, such as a passport, a voter's or national ID or a driving license among others.[468]

The Reserve Bank of Malawi (RBM) is also on the way to formalize even those traders who cannot afford the capital required to open bureaus, following pronouncements made by Financial Intelligence Unit that parallel foreign exchange traders need to be regulated.

The report states that, bringing black market forex traders into the formal market will enable the central bank to know how much cash is coming into the country and spent. The fact is that majority of forex traders may not afford the capital required to open bureaus and not all those traders around shopping malls would want to do something illegal. As a result, their operating guidelines would be different from the bureaus that have permanent buildings or places. Some forex dealers will opt not to be registered but those registered will be given identities and allowed to trade freely. [469]

[467] Nita Ghei and Steven B.kamin , *the use of the parallel market rate as a guide to setting the official exchange rate,* p 503

[468] Illegal forex business booms, Business Day, Business News of Wednesday, 30 November 2016 https://www.ghanaweb.com/GhanaHomePage/business/Illegal-forex-business-booms-491156, (last accessed May 14/2018)

[469]Nyasa time reporter: https://www.nyasatimes.com/malawi-legalise-forex-black-market-traders-kwacha-trading-around-k730-dollar/ (last accessed May 25/2018)

Chapter Five

Conclusion and recommendation

5.1 Conclusion

The root problem for the existence of parallel market in Ethiopia like many other developing countries is foreign exchange restrictions. The cause for the existence of foreign exchange restriction is shortage of foreign currency which hinders the formal market to provide the amount demanded. The heavy dependence of domestic production and consumption on the import of raw materials, capital and consumption goods have exacerbated the foreign currency shortage as earnings from export cannot finance the required foreign currency for imports. The Ethiopian government is providing different incentives to boost the Export sector to increase the foreign exchange accessibility though the expected result is not achieved for different problems discussed. While the export sector is the primary sector for enhancing the foreign exchange earnings, there are various bottlenecks that prevent the sector from playing its role in the development of the national economy. Researches also show that the effectiveness of the existing export incentives is substantially constrained by the lack of efficient export bureaucracy and coordination problem.

The government responded for the shortage of foreign currency by different legal and policy measures. The NBE enacted different directives determining who, how much and in what conditions foreign currency is accessible in the formal channel. These restrictions born the parallel market as it did in many other developing countries. The government has been treating this market as an illegal activity for more than four decades. All previous proclamations authorized only banks to make foreign exchange transactions.

However the current NBE establishment proclamation, (591/2008) allows other dealers other than banks to engage in foreign exchange transactions. It provides two ways of enforcement of the proclamation on the parallel market. The first one is licensing the parallel market dealers and regulating the market under Ethiopia's foreign exchange regulation. The other one is prohibiting the parallel market dealers legal recognition and excluding the parallel market from Ethiopia's foreign exchange regulation.

NBE so far authorizes only banks to make such transactions. As a result the parallel market dealers are working without license. The act is an illegal act with harsh penalty in the criminal code of Ethiopia. However the market still persists more than ever. The government has been trying to avoid the market through different policy measures but none of them was effective in shutting down the market.

Such approach of the country has become detrimental to the economy. Since the NBE make them illegal and exclude the market from the ambit of the foreign exchange regulation, the numerous parallel market dealers are working without authorization. Hence, those parallel exchange dealers are left with no duty of reporting the volume and manner of transactions. This approach has negative effects on the economy. The country has no transparent capital inflow and out flow; the foreign currency in the formal market is drying; illicit activities like money laundering and terrorism financing are potential risks and the government is unable to allocate foreign exchange. The parallel market also create suitable environment for contraband trade affecting tax revenue of the country.

Though the way is informal, however, the excess demand for foreign currency is being satisfied by the parallel market. The parallel market is financing not only importers but anyone who needs foreign currency. The formal channel can't satisfy such demand due to shortage of foreign currency in the formal channel. Thousands of travelers travelling daily out of Ethiopia are being financed by the parallel market. Education fee, medical payments, and other invisible payments of the country are being financed by this market. The parallel markets are assisting the economy by reducing the burden of banks in financing different payments.

Given the importance of the parallel market, actions in this area should not aim to ban the transactions. Such an approach has been attempted in several developing countries but didn't achieve its intended goal. Researches show that it is unlikely that efforts to stop the parallel market would succeed unless the country can fully satisfy the demand of foreign currency without restrictions. Even the threat of capital punishment did not totally wipe out the parallel market in Sudan between 1970 and 1990 .Whatever happens, there will still be a huge demand for parallel market and it is better that such services remain open.

Unless regulated, parallel market could become more prone to other illegal activities as part of or in parallel with their operations**.** The fear that parallel market may create capital flight, money laundering, loss of control on the foreign exchange etc can be solved not by curtailing them but by regulating them. The government will have a means of tracking and monitoring the capital fleeing from the country through parallel market. Their transparency should be enhanced through supervision to minimize the risk of financial abuse and other illicit activities.

Unregulated routes are difficult for the financial intelligence center (FIC) and other authorities to monitor and assess. Regulating them increase the level of transparency and bring overall business activity within the scope of all the regulatory requirements like anti-money laundering legislation. Accordingly, the purpose of any measure related to parallel market should be the regulation. The government can also collect tax from licensed dealers which can be another advantage of legalizing the market. However the market by its very nature doesn't welcome strict control from the government. The supervision of this market should not be excess as far as possible.

Ethiopia should take lessons from other African countries like Ghana, Uganda and Malawi where the penalty for parallel market dealers was high. These countries eventually legalize the market by taking lessons from their previous experience that making the market out of the ambit of the country's foreign exchange regulation was detrimental to the economy.

Migrant remittances account for over 5 per cent of the Gross Domestic Product (GDP) of Ethiopia and one quarter of the country's foreign exchange earnings. The value of incoming remittances exceeded the country's export earnings. However 78% of this foreign currency is passing through the informal remittance which can be taken as the other face of parallel market traditionally named *as 'Hawala;* Lack of access to services in the send and receive markets, high direct and indirect costs associated with formal channels, irregular migration, the existence of parallel market exchange rates, and regulatory barriers for undocumented migrants contribute to the high level of informal transfers. The Ethiopian economy is highly affected by the "*hawala*" market. The government cannot allocate 78% of the foreign currency the country has for its policy implementation. The formal channel's foreign currency is dried while the parallel market is mobilizing the country's foreign currency by individuals who are not granted legal recognition. Formal channels are in severe shortage of foreign currency slowing down the overall performance of the country's economy.

However the government is not making any attractive incentive to use the remittance fully. The zero payment cost is not an incentive while the parallel market are providing incomparable attractive rate. Zero payment and the remittance lottery are not incentives comparing with the informal *'hawala'* system. The government is simply giving a blind eye for this detrimental system. The migrants providing foreign currency for the country should be awarded with something that makes the Ethiopian abroad prefer the formal channel. The incentives given by other countries like Brazil, Morroco, Ecuador and India are appreciable. Only when the government can provide an incentive that exceeds the incentives given by informal channel that the Ethiopian government can secure the huge foreign currency from abroad.

Regarding the Undocumented migrants, it is estimated that 60-70 percent of migrants travelling to Gulf States are undocumented and as a result unable to remit through formal channel because of their migration status. This figure may be greater for migrants travelling to Southern Africa. Therefore, Ethiopia is losing huge foreign currency in the formal channel. The most relevant global example of this solution has been used by Mexican nationals in the United States where the Mexican Government has issued a document called the *matricula consular*. In turn, financial institutions in the United States accept the *matricula consular* as a valid form of identification for the purpose of conducting a range of financial services.

The effectiveness of the incentives in diverting the remittances to the official channels depends crucially on the ability of the formal financial infrastructures to compete with the informal market. The popularity of informal channels of remittances could not be attributed solely to the better exchange rates offered. Migrant workers turn to them because of efficient and speedy service, coverage of areas without banking facilities as well as innovative remittance methods designed to suit overseas workers.

5.2 Recommendation

- The government should increase its efforts to boost the export sector. Correcting all the problems surrounding the export sector is irreplaceable solution for all problems arising from foreign currency shortage. Administrative related issues should be given special attention. Continuous and targeted training for local exporters who are engaged in the main export items is instrumental in boosting efficiency and competiveness in the sector. The government, private sector, private and public financial institutions, exporters, institutes of higher learning, cooperative unions should be collaborated enough to achieve attractive result on the export sector.
- The Ethiopian government should license and legalize the parallel market dealers. The government should absorb the parallel market dealers in to the formal market by giving legal recognition through licensing. In doing so the government can apply the foreign exchange regulation in the parallel market. This will result regulated foreign exchange market in the country. Through licensing, the government can create reporting mechanism which enable the central bank to know how much cash is coming into the country and spent which is a necessary input for policy makers for effective monetary and economic policy.
- The Government should channel the huge foreign currency flowing in the illegal parallel market in to the formal channel by making the market under the ambit of foreign exchange regulation. This makes the foreign currency in the parallel market to be mobilized and operate under foreign exchange regulation. Licensing the parallel market dealers enables them to be legal business operators. In doing so, the foreign currency in the parallel market start to operate under the regulated system and can activate the country's economy which has been challenged by shortage of foreign currency in the formal cannel. In this way the government can reduce problems arising from shortage of foreign currency in the formal channel. The government can also collect taxes from licensed parallel market dealers.
- The government should apply the foreign exchange regulation on the parallel market to control illicit activities like capital flight, money laundering and terrorism financing which are hardly possible to control in unregulated market.

- To reduce the informal remittance passing through the informal transfer system, the government of Ethiopia should allow broader access to foreign exchange by licensing the parallel market operators. Giving broader access to foreign exchange, bring a larger portion of the country's substantial remittance flows into the regulated financial sector. If the importers can access the foreign currency locally, the motive of using informal transfer system to finance its imports will reduce significantly. Legalizing the parallel market has the effect of channeling informal remittance in to the regulated parallel market. Giving broader access to foreign exchange in the local market bring a larger portion of the country's substantial remittance flows into the regulated financial sector.
- The other alternative solution to direct the huge foreign remittance in to the formal market is increasing incentives. Incentives provided by banks for remitter should exceed the incentives given by the informal transfer system or *hawala system*. In this regard, the NBE should take lessons from Brazil which channel small portion of regularly transferred remittance for production use; from Morocco which provides subsidized credit for real state ; from India which arrange private partnership for the migrants abroad; from Ecuador which provide tax exemptions for returning migrants in housing and working equipment; from Mexico and Philippines which allow migrants the national pension and health care schemes by making bilateral agreements seeking to avoid double contribution in both host and destination countries. Ethiopia should take lesson from these countries in increasing incentives considering the country's economic capacity.
- Ethiopia should take lesson from Mexico to use the remittances of illegal migrants by making an agreement with the host country in which large numbers of illegal migrants live/work. This would have great positive impact on enabling many illegal Ethiopian migrants to use formal services.
- The government should expand the banking services in rural parts of Ethiopia. Supporting microfinance institution in rural areas to become sub-agents of banks ease the problem of Banks coverage.

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3. Interview with Zelalem Getnet, officer in the External sector research department in NBE, *On NBE directives to combat the parallel market*, May 25/2018
4. Interview with MS. Zemzem Mohammed, An economist working in the economics research department in NBE, *on the effectiveness of the NBE directives in combating the parallel market,* April 7/2018
5. Interview with Ato Dereje Getahun, Manager of foreign exchange department in Awash international bank head office, *on the impact of parallel market*, April 18 /2018
6. Interview with Betre Mekonnen, Customer relation officer in Ethiopian commercial bank, Mehetema Ghandi branch, *on the incentives given by Banks to enhance remittance from abroad*, May 26/2018
7. Interview with Ato Seimon Fenta, commissioner in Addis Ababa police commission, *on the effectiveness of controlling parallel market*, April 17/2018
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9. Interview with Ato Zeynu Mohamed, importers of different items from different countries, *on how to access foreign currency*, April 7/2018
10. Interview with anonymous Commercial bank Manager, *on the foreign exchange allocation*, April 16,2018
11. Interview with anonymous parallel market dealer working in Merkato, Addis Ababa, *on the operation of the parallel market,* April 13/2018
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13. Interview with anonymous parallel market dealer working in American gibi,on *the operation of the parallel market*, April 7/2018
14. Interview with anonymous importer , *on how to access foreign currency*, April 26/2018

APPENDICES

Interview Questions

Interview questions for NBE experts

1. Who are authorized dealers under the establishment proclamation?

2. How do you see the exclusion of parallel market from Ethiopia's foreign exchange regulation?

3. What are the restrictions in accessing foreign currency in the formal market?

4. How do you see the parallel market proliferation despite the government efforts to avoid the market?

5. What are the impacts of parallel market on the Economy?

6. Do you think parallel markets are supporting the formal market in some way?

5. What measures are taken by the NBE in avoiding the parallel market?

6. Are the measures effective in reducing the problem?

7. What directives are enacted primarily to avoid the parallel market?

Interview questions for Bank Managers (Private and public bank)

1. How do you see the exclusion of parallel market from Ethiopia's foreign exchange regulation?

2. Is the foreign exchange transaction in your bank is affected by the parallel market and in what way?

3. What incentives are available in your banks to enhance remittance from abroad?

4. What do you think the reason for huge informal transfer system than banks?

5. How do you see the effectiveness No FXD 53/2018 in controlling under invoicing?

Interview questions for importers?

1. How do you access foreign currency for your importation?

2. Do you use parallel market for your importation and why?

3. What makes you to prefer parallel market than formal market?

4. How do you see directive No 53/2018 in making importers to use only formal market for foreign currency?

Interview questions for parallel market dealers

1. How do you operate foreign exchange transactions?

2. What are the supply and demand for your market?

3. How much foreign currency is exchanged per day?

4. What are the major buyers and providers of foreign currency for your market?

Interview questions for Addis Ababa police commission

1. Why the parallel market is active despite their illegality in the criminal code?

2. How do you control the parallel market dealers?

3. Do you think that making parallel market dealers criminally liable effective in avoiding the parallel market?

4. How do you see the existence of parallel market for more than four decades?

5. Why some parallel market dealers are operating openly in some corridors in Addis Ababa?