

Exiting Financial Repression

The Case of Ethiopia

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Abstract

Ethiopia's framework for managing its monetary and foreign exchange policy has relied on some standard instruments of financial repression. Over time, the framework has led to the buildup of large macro-financial imbalances. Exiting financial repression while maintaining macroeconomic

stability would require solid control over the macro-financial flows and good anticipation of the immediate financial effects of the reform. The paper presents and quantifies such a gradual liberalization reform scenario of Ethiopia's monetary and foreign exchange system.

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Exiting Financial Repression: The Case of Ethiopia

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“Before direct central government controls are fully dismantled, the monetary-financial-fiscal system has to be converted from the passive mode that had simply accommodated the planning mechanism into an active constraining influence on the ability of decentralized enterprises, households, and even local governments to bid for scarce resources. Implementing such financial and fiscal restraint at the microeconomic level permits the aggregate domestic price level to be stabilized by a suitable choice of monetary policy without resorting to direct controls over prices.” -- Ronald I. McKinnon, 1993

1. Introduction

Ethiopia’s framework for managing its monetary and foreign exchange policy has relied on some standard instruments of financial repression. These include the central bank financing of the government, a state-dominated banking sector, mandatory financing of priority projects and directed credit, administered interest rates, a captive domestic market for government debt, high liquidity and capital requirements, and strict foreign exchange controls. This brief introduction aims at presenting the terms of the debate: what is financial repression and its prevalence in economic history, what are the costs and benefits of repressed financial systems, and what a typical blueprint to exit financial repression entails?

1.1. What is financial repression?

Financial repression refers to the notion that a set of government regulations, laws, and market restrictions captures a substantial proportion of the resources of the financial system for funding the public sector at below market prices.² Such policies include directed lending to government by captive domestic audiences (such as pension funds), explicit or implicit caps on interest rates, credit ceilings or restrictions on directions of credit allocation, restrictions on market entry into the financial sector, exchange and capital controls, high liquidity ratio requirements and bank reserve requirements, and government ownership or domination of banks (see Box 1). Governments have typically used a mix of these policies to bring down domestic debt levels and direct savings to priority purposes. When financial repression produces negative real interest rates and reduces or liquidates existing debts, it is a transfer from creditors (savers) to borrowers (government and private).

Box 1: The Pillars of Financial Repression

According to Reinhart and Sbrancia (2011),³ a system of financial repression is characterized by the following main key features:

Explicit or indirect caps or ceilings on interest rates, particularly (but not exclusively) those on government debts. These interest rate ceilings could be effected through various means including:

² As coined by Ronald McKinnon (1973) and Edward Shaw (1973), the term “financial repression” describes various policies that allow governments to “capture” and “under-pay” domestic savers. It prevents the financial intermediaries of an economy from functioning at their full capacity. McKinnon, Ronald I. (1973). *Money and Capital in Economic Development*, Washington, DC: Brookings Institute. Shaw, Edward S. (1973). *Financial Deepening in Economic Development*. New York: Oxford University Press.

³ Reinhart, Carmen M. and M. Belen Sbrancia (2011). *The Liquidation of Government Debt*. NBER Working Paper No. 16893.

- Explicit government regulation (for instance, Regulation Q in the United States prohibited banks from paying interest on demand deposits and capped interest rates on saving deposits);
- In many cases ceilings on banks' lending rates were a direct subsidy to the government in cases where the government borrowed directly from the banks (via loans rather than securitized debt);
- The interest rate cap could be in the context of fixed coupon rate nonmarketable debt or it could be maintained through central bank interest rate targets (often at the directive of the Treasury or Ministry of Finance when central bank independence was limited or nonexistent).

Creation and maintenance of a captive domestic audience that facilitated directed credit to the government. This was achieved through multiple layers of regulations from very blunt to more subtle measures.

- Capital account restrictions and exchange controls orchestrated a “forced home bias” in the portfolio of financial institutions and individuals under the Bretton Woods arrangements;
- High reserve requirements (usually non-remunerated) as a tax levy on banks;
- Among more subtle measures, “prudential” regulatory measures requiring that institutions (almost exclusively domestic ones) hold government debts in their portfolios (pension funds have historically been a primary target);
- Transaction taxes on equities also act to direct investors toward government (and other) types of debt instruments;
- Prohibitions on gold transactions.

Other common measures associated with financial repression aside from the ones discussed above are direct ownership (China or India) of banks or extensive management of banks and other financial institutions (i.e. Japan). Restrictions of entry to the financial industry and directing credit to certain industries are also features of repressed financial markets.

1.2. Financial repression in economic history

Most countries around the world—developing and developed alike—have experienced forms of financial repression at some point or another since World War II.⁴ Liberal capital market regulations and international capital mobility reached their heyday in the early 1900s. To deal with the debt accumulated during the two World Wars and the Great Depression, most advanced countries experimented with financial repression policies in the 1940s. These policies lasted in one form or another until the early 1980s when the move towards financial and capital account liberalization opened a new era of liberal capital market regulation.⁵ Like with the advanced countries after WWII, many developing countries in Africa, East Asia and Southeast Asia, Latin America and Central and Eastern Europe experimented with financial repression between the 1960s and 1990s to support state-led industrialization and import substitution

⁴ Hoffmann, Andreas (2017). Beware of Financial Repression: Lessons from History. Available at SSRN: <https://ssrn.com/abstract=3124184>

⁵ Reinhart, Carmen M. and M. Belen Sbrancia (2011). The Liquidation of Government Debt. NBER Working Paper No. 16893.

strategies and deal with the associated fiscal and debt challenges.⁶ However, given the mixed results of these policies (including the Latin American and African debt crises of the 1980s and 1990s and the economic collapse of the socialist economies in Central and Eastern Europe and the former Soviet Union in the early 1990s), and in light of the successful experience of Japan and some small tiger states that have experimented with economic and financial liberalization in the 1960s and 1970s, many developing countries began to liberalize their economic and financial systems in the 1990s and 2000s.

1.3. Cost and benefits of repressed financial systems

The main benefits of financial repression are to capture savings and keep nominal interest rates lower than would otherwise prevail. By having direct control over the financial system, the government (and the public sector at large) can capture private funds without going through legislative procedures and more cheaply than it could when it resorts to market financing. It could then directly allocate domestic savings to public uses or private firms or sectors that are considered strategic or to be prioritized, such as exporters or manufacturers. Below-market interest rates have the effect, other things equal, to reduce the public sector's interest expenses for a given stock of debt and contribute to deficit reduction. Indeed, teamed with a steady dose of inflation, financial repression cuts domestic debt burdens from two directions: via low nominal interest rates and reduced debt servicing costs; and via a tax on savers (negative real interest rates) to erode the debt-to-GDP ratio.⁷ The evidence indicates that the revenue from financial repression can be quite substantial but varies significantly across countries.⁸ Financial repression can be optimal when governments need to issue unusually large amounts of debt, such as during wartime.⁹ An argument has also been made that financial repression policies may have positive effects whenever they are able to successfully address market failures. In a context of imperfect information, for instance, interest rate restrictions may be able to address moral hazard in the form of excessive risk taking by banks; thereby enhancing the stability of the banking system and increasing the willingness of depositors to hold their savings in the form of bank deposits.¹⁰ When restrictions on market entry and exchange and capital controls are in place, financial repression has also the effect of protecting the domestic banking system from the contagion of international financial crises.

The main costs of financial repression are to gradually distort resource allocation, reduce economic efficiency, and inhibit financial deepening. Because excessive financial repression leads to inefficient

⁶ Giovannini, A. and M. de Melo (1993). Government Revenue from Financial Repression, *The American Economic Review* 83, 4, 953–963.

⁷ Reinhart, Carmen and Jacob Kirkegaard (2012). Financial repression: Then and now. VoxEU CEPR Policy Portal. <https://voxeu.org/article/financial-repression-then-and-now>

⁸ Giovannini, Alberto and Martha de Melo (1993). Government Revenue from Financial Repression. *American Economic Review*, Vol. 83, No. 4 (Sep 1993), pp. 953-963. In this study of 24 developing countries in the 1980s, the authors found that revenue from financial repression reached up to 5 percent of GDP in Mexico and Zimbabwe and 20 percent or more of total government revenue (excluding the revenue from financial repression) in India, Mexico, Pakistan and Sri Lanka. The same orders of magnitude were found in Reinhart, Carmen M. and M. Belen Sbrancia (2011). *The Liquidation of Government Debt*. NBER Working Paper No. 16893.

⁹ Chari, V., Alessandro Dovis, and Patrick J. Kehoe (2018). On the Optimality of Financial Repression. Federal Reserve Bank of Minneapolis, Research Department Staff Report 1000.

¹⁰ Stiglitz, Joseph E. (1993). The Role of the State in Financial Markets, in proceedings of the World Bank Annual Conference on Development Economic, 19-52, Washington DC.

allocation of capital, high costs of financial intermediation, and lower rates of return to savers, it tends to reduce economic efficiency and growth.¹¹ Overall, the empirical findings on the effect of financial repression support this view, and various channels through which financial repression hinders growth have been evidenced. By pushing long-term interest rates downward, central banks are keeping growing general government debt levels sustainable and are discouraging discipline in government finances—crowding out the private sector. Public sector expenditure by the government and state-owned enterprises (SOEs) financed by money creation and capture undermined the efficiency of investment. With state-controlled interest rates, economic agents are provided with misleading signals, which undermine the optimal allocation of capital. If financial repression reaches the point of undermining the innovation process by binding resources in less efficient investment projects and reducing the incentive for household savings, then investments, productivity gains, and economic development will slow. Furthermore, inflated central bank balance sheets, which contain growing amounts of government bonds, erode the credibility of central banks. Negative real interest rate policies inhibit financial deepening and could even lead to financial meltdowns, during which the exploding debts of financial institutions, especially state-owned banks, are transformed into public debt to ensure financial stability. In the case of India, it was found that financial repression had a negative impact on financial depth, beyond and above the effects of the real rate of interest.¹² Capital controls are also financially repressive policy. Despite their virtues, the use of capital controls involves costs. Because of their uncompetitive nature, capital controls increase the cost of capital by creating financial autarky; limit both domestic and foreign investors' ability to diversify portfolios; and help inefficient financial institutions survive.

From a more political economy perspective, financial repression may lead to growing economic inequality and policy opposition.¹³ Unlike other taxes, the financial repression “tax” is determined by financial regulations and inflation performance that are largely opaque to the public and economic actors. Given that fiscal deficit reduction usually involves highly unpopular expenditure reductions and/or tax increases of one form or another, the relatively “stealthier” financial repression tax may be a more politically palatable alternative for authorities faced with the need to reduce outstanding debts. However, even if the impact of financial repression is opaque in the short-term, it discretionarily creates winners and losers, with the latter likely to call for policy change in the long run. The causality between increasingly loose monetary conditions and political destabilization goes in both directions. First, preferential access to low interest rate credits benefits certain firms, sectors or regions to the detriment of others, thereby increasing the likelihood of political dissatisfaction. Second, the resulting loss of support for the established policy typically triggers additional redistribution efforts by the government, which aims to restore political stability. To finance the additional government expenditure, additional issuance of below market rate government securities becomes necessary, which initiates a new round of adverse redistribution effects of monetary expansion. Because growing political instability constitutes a severe

¹¹ Roubini, N. and X. Sala-i-Martin (1992). Financial Repression and Economic Growth, *Journal of Development Economics* 39, p. 5 – 30.

¹² Demetriades, Panicos and Kul B. Luintel (1997). The Direct Costs of Financial Repression: Evidence from India. *The Review of Economics and Statistics*, Vol. 79 No. 2, pp. 311-320, The MIT Press.

¹³ Duarte, P., and Schnabl, G. (2017). Monetary Policy, Income Inequality and Political Instability. CESifo Working Paper 6734.

threat for welfare and peace, an exit from financial repression is often necessary when the costs outweigh the benefits.

1.4. Blueprint for exit from financial repression

Much debate surrounds the issue of the timing, sequencing, scope, and pace of financial liberalization, especially in relation to developing countries' development strategies.¹⁴ The McKinnon-Shaw hypothesis assumes that as controls on the economy are lifted through liberalization, its association with higher real interest rates would stimulate savings, which encompasses an underlying assumption that savings is responsive to interest rates and more broadly that savings is a key determinant of growth. With the real interest rate adjusting to the equilibrium level, low-yielding investment projects would be eliminated, enhancing the overall efficiency of investment projects. These savings rates would then finance a higher level of investment and thus, higher growth.¹⁵ Economic liberalization would have the additional benefit of promoting transparency and accountability, thereby reducing adverse selection and moral hazard while alleviating liquidity problems in the market.¹⁶ However, despite the prevailing theories, many have noted that, contrary to the experience of developed countries, developing countries that have undertaken the process of financial liberalization over the past 50 years have had mixed experiences.¹⁷ Financial liberalization has not always led to higher growth, in part because of the weak link between real interest rates and savings, in turn due to the poor quality of institutions and inappropriate sequencing of liberalization and institutional reforms in many developing countries.¹⁸

The exit from financial repression in developing countries requires the appropriate sequencing of institutional build-up and reconstitution of market forces.¹⁹ Because of the use of financial institutions as captive investors in public debt, many developing countries have not developed the legal environment and the dedicated national debt offices at the ministry of finance and central bank, staffed with skilled

¹⁴ This literature review draws on Miho, Antonela (2015). Do free markets imprison? The effects of economic liberalization and financial deregulation in developing countries during external economic booms and crises. <http://economics-files.pomona.edu/GarySmith/Econ190/Econ190%202015/Antonella%20Miho.pdf>

¹⁵ McKinnon, Ronald I. (1973). *Money and Capital in Economic Development*, Washington, DC: Brookings Institute. Shaw, Edward S. (1973). *Financial Deepening in Economic Development*. New York: Oxford University Press.

¹⁶ Stulz, René M. (1999). Globalization of Capital Markets and the Cost of Capital. *Journal of Applied Corporate Finance* Vol. 12(3), pp. 8-25. Mishkin, Frederic S. (2001). *Financial Policies and the Prevention of Financial Crises in Emerging Market Countries*. NBER working paper No. 8087.

¹⁷ Giovannini, Alberto, (1985). "Saving and the Rate of Interest in LDCs," *Journal of Development Economics*, Vol. 18, pp. 197-217. Ostry, Jonathan D., and Carmen M. Reinhart, 1992. "Private Saving and Terms of Trade Shocks: Evidence from Developing Countries," *Staff Papers, International Monetary Fund*, Vol. 39, pp. 495-517. Reinhart, Carmen M. and Carlos A. Végh, 1995. "Intertemporal Consumption Substitution and Inflation Stabilization: An Empirical Investigation," *University of Maryland Working Papers in International Economics* No. 3. Bandiera, G. Caprio, P. Honohan, and Schiantarelli (2000). "Does Financial Reform Raise or Reduce Saving?, *Review of Economics and Statistics*, May, 82(2): 239-263. ; Loayza N., K. Schmidt-Hebbel, and L. Servén (2000). "What Drives Private Saving Across the World? *Review of Economics and Statistics*, May 2000, 82(2) :165-181.

¹⁸ Graciela Laura Kaminsky and Sergio L. Schmukler, 2008. "Short-Run Pain, Long-Run Gain: Financial Liberalization and Stock Market Cycles," *Review of Finance*, Oxford University Press for European Finance Association, vol. 12(2), pages 253-292.

¹⁹ McKinnon, Ronald I. (1993). *The Order of Economic Liberalization: Financial Control in the Transition to a Market Economy*. Baltimore: The Johns Hopkins University Press.

professionals and entrusted with the task of promoting efficient domestic debt market. Reconstituting market forces does not automatically mean that countries should adopt a laissez-faire stance on financial development and remove all regulations and controls that create financial repression. Many developing countries that liberalized their financial markets in the 1990s experienced crises partly because of the external shocks that financial liberalization introduces or amplifies. Financial liberalization can create short-term volatility despite its long-term gains.²⁰ Also, because of market imperfections and information asymmetries, removing all public financial regulations may not yield an optimal environment for financial development. An alternative to a financially repressive administration is generally a new set of regulations to ensure market competition as well as prudential regulation and supervision.

Furthermore, the exit from negative or low interest rate policies is strongly dependent on public debt levels. Every significant increase in interest rates threatens to cause a meltdown in the financial system and (thereby) to derail the budgets of highly indebted countries. So, fiscal and monetary consolidation must precede the liberalization of financial markets, otherwise the low-cost liquidity provision of central banks would trigger destabilizing turmoil in financial markets. For many countries, government revenue from financial repression is of the same order of magnitude as the revenue from seigniorage.²¹ Moreover, there is evidence of some complementarity between seigniorage and financial repression: in general, countries with higher rates of inflation and, therefore, higher rates of currency depreciation tend to raise more revenue from financial repression. To achieve a successful exit strategy, which avoids major meltdowns in the financial sector and the bankruptcy of highly indebted states, the process has to be simultaneously credible, gradual, transparent, sequenced along the yield curve, and coordinated (see Box 2). This blueprint has proven to be highly successful in many East Asian as well as Central and Eastern European countries, and in particular in China.²²

Box 2: The Exit Blueprint from Financial Repression

According to Edwards (1984) and McKinnon (1993),²³ there are limits on the relative speeds of liberalization in commodity and capital markets and how far interventionist policies or planning controls over domestic and foreign trade can be withdrawn. How fiscal, monetary and foreign exchange policies are sequenced is of critical importance. Government cannot, and probably should not, undertake all liberalizing measures simultaneously. Instead, according to McKinnon (1993) there is an optimal order of economic liberalization, which varies for different liberalizing economies depending on their initial conditions,²⁴ but whose common principles include:

²⁰ Kaminsky, Graciela, and Sergio Schmukler (2002). Short-Run Pain, Long-Run Gain: The Effects of Financial Liberalization, World Bank Working Paper No. 2912, Washington DC.

²¹ Giovannini, Alberto and Martha de Melo (1993). Government Revenue from Financial Repression. American Economic Review, Vol. 83, No. 4 (Sep 1993), pp. 953-963.

²² Schnabl, Gunther (2018). Exit Strategies from Monetary Expansion and Financial Repression. CATO Journal. Spring/Summer 2018. Washington D.C.

²³ Edwards, Sebastian (1984). The Order of Liberalization of the External Sector. Princeton Essays on International Finance, No. 156.

²⁴ It should be noted at the outset that Ethiopia does not feature some of the most extreme forms of financial repression that were present in the Soviet Union, China and other socialist countries in the late 1980s and that, accordingly, Ethiopia's transition from financial repression will be facilitated by its more favorable initial conditions.

First, fiscal control should precede financial liberalization. Successful liberalizing governments must levy broadly based, but low-rate, taxes on both enterprises and households. The sine qua none of successful reform is an internal revenue service capable of collecting taxes in a decentralized market setting. Until a fully-fledged tax system can be put in place, industrial and natural assets best remain government-owned as revenue sources for the public treasury.

Second, indirect (off-budget) government spending should either be folded into the regular budget or phased out. To protect the central bank from being forced into the excessive issue of domestic base money, off-budget government subsidies and the losses occurred by the central bank in supplying foreign exchange, domestic credit or deposit insurance too cheaply to SOEs and other preferential economic agents, should be transparently reported in the government regular budget.

Third, the domestic capital market should open so that depositors receive, and borrowers pay, substantial real (inflation-adjusted) interest rates. Once tight fiscal controls are in place, so that the government no longer has to rely on the inflation tax or undue reserve taxes on depositors to generate revenue, the banking system should be freed from onerous reserve and liquidity requirements and official guidance in setting interest rates on deposits and loans.

Fourth, the pace of deregulation of banks and other financial institutions should be aligned on the government's success in preserving overall macroeconomic stability. Without price level stability, unpredictable volatility in real interest rates or exchange rates makes unrestricted domestic borrowing and lending by deposit-taking banks (which must always be regulated to ensure the safety of the payments mechanism) simply too risky. In case of inflationary pressure or great moral hazard in bank lending, the central bank should strictly limit the injection of liquidity until the price is level stabilized, and enterprises should be encouraged to rely on self-finance, on borrowing from nonmonetary financial sources, and on broadening capital participation in the enterprise itself.

Fifth, private capital markets not based on deposit-taking (money issuing) banks can operate relatively freely at the outset of the liberalization. The government should move quickly to establish a framework of commercial law in which private debt contracts are adjudicated and, if necessary, enforced by the state for all enterprises and households. However, as long as the future price level is uncertain (thus leaving the economy without any standard of deferred payment), the natural (unsubsidized) development of longer-term bond or equity markets is virtually impossible, even with contractual enforcement mechanisms in place.

Sixth, after the (successful) liberalization of domestic trade and finance, there is an appropriate pace for the liberalization of foreign exchange, starting with full convertibility for current account operations. The unification of the exchange rate for all current account transactions—so that every importer and exporter deals with the same effective price of foreign exchange—should precede the elimination of controls on who can export or import (licenses). Then, international trade can be gradually liberalized by first converting any quantitative restrictions into tariff equivalents, and second aligning the tariff schedule on that of main competitors.

Seventh, once the conditions are met in terms of macroeconomic stability, fiscal consolidation, banking system soundness, and sufficient level of international reserves, the liberalization of the capital account would be the last stage in the optimal order of liberalization. Before allowing enterprises (or households) to borrow freely from, or deposit in, international capital markets, the domestic capital market should be fully liberalized, which in turn depends on the elimination of substantial reserves

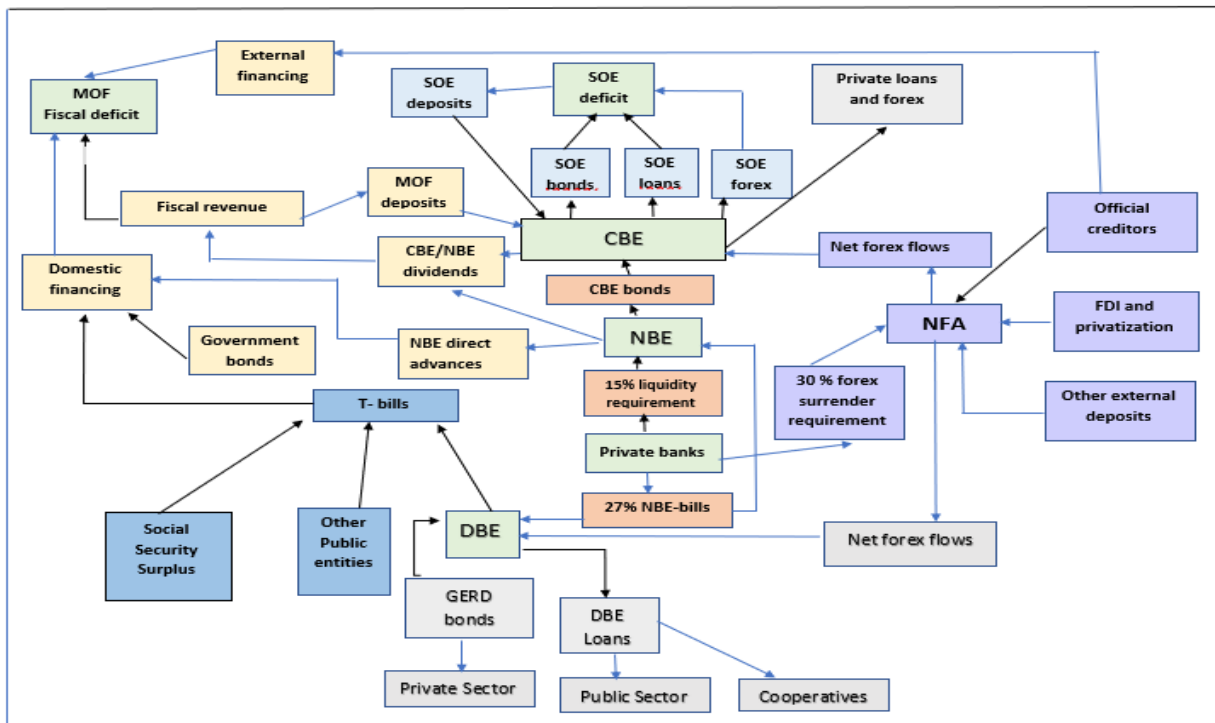
taxes on domestic banks. As long as domestic banks remain restricted and heavily taxed, it is pointless—indeed destructive—to allow foreign banks or foreign financial institutions to operate freely in domestic financial markets. Even more destabilizing is to allow hard foreign currencies to circulate in parallel with the unconvertible national currency. Only when domestic borrowing and lending take place freely at unrestricted rates of interest and the domestic rate of inflation is curbed so that ongoing depreciation in the exchange rate is unnecessary are the arbitrage conditions right for allowing free international capital mobility.

The rest of the paper is organized as follows: Section 2 presents the specific instruments of financial repression in Ethiopia; Section 3 reviews some of their stylized effects on the economy; Section 4 discusses the possible pathways out of financial repression; Section 5 presents a transitional macro-financial programming scenario and its impact; and Section 6 provides some conclusions and preliminary recommendations.

2. Instruments of financial repression in Ethiopia

Financial repression is deeply entrenched in Ethiopia and includes many of the standard instruments of repression. These include the central bank financing of the government, a state-dominated banking sector, mandatory financing of priority projects and directed credit, administered interest rates, a captive domestic market for government debt, high liquidity and capital requirements, and strict foreign exchange controls. The instruments used and directions of macro financial flows among public and financial institutions are summarized in Chart 1.

Chart 1. Ethiopia: A Summary of Financial Repression Instruments and Flows of Funds



2.1. Central bank financing of the government

The National Bank of Ethiopia (NBE) is not independent from the government. While the NBE is legally an “autonomous institution” as stated in both the 1994 and 2008 NBE Establishment Proclamations,²⁵ it is required to meet the government’s requests for credits and advances for each fiscal year (Article 13.1). Over time, the status and purpose of the NBE have evolved, with the 2008 Proclamation making it less autonomous and less oriented toward macroeconomic stability than the 1994 Proclamation that established the NBE. A new article was introduced in the 2008 Proclamation to make the NBE explicitly accountable to the Prime Minister (Article 3.4) and the purpose of the NBE was amended to include “a stable rate of exchange” and “activities that are conducive to rapid economic development” (Article 4) as opposed to “balanced growth of the economy”.²⁶ The relation of the NBE with the government was also amended. While the 1994 Proclamation set numerous constraining limits to government borrowing from the NBE (Article 25.3) and subjected it to the “maintenance of monetary stability and balance of payment equilibrium” (Article 25.2),²⁷ the 2008 Proclamation removed the limits to government borrowing and subjected it only to the “maintenance of price and exchange stability” without specific references to internal and external imbalances (Article 13.1). Another important change in the 2008 Proclamation was to authorize the NBE to issue its own debt and payment instruments (Article 5.3).

The NBE is engaged in large direct and indirect quasi-fiscal operations. One effect of the NBE’s dependence on the government is that the NBE provides direct advances to the government to finance the budget on an annual basis. In 2017/18, the NBE extended advances of birr 24.5 billion to finance the government deficit (1.1 percent of GDP). The outstanding NBE advances to the government are large and have been growing over time. As of end-September 2018, the NBE’s outstanding claims on the government amounted to birr 166.7 billion (corresponding to 7.6 percent of GDP or 95.3 percent of the monetary base or reserve money). These claims increased by 18.1 percent during 2017/18 and by an average of 20 percent over the past five fiscal years. The NBE also provides indirect financing to the government by extending credit to the Development Bank of Ethiopia (DBE) to purchase T-bills. In 2017/18, such credit amounted to birr 17 billion. Thus, the total direct and indirect financing of the government by the NBE amounted to birr 41.5 billion in 2017/18. In addition, the NBE provides indirect financing of SOEs by granting liquidity to the Commercial Bank of Ethiopia (CBE) in the form of 5-year bonds, which amounted to birr 27 billion in 2016/17.²⁸

²⁵ Proclamation No. 83/1994 and Proclamation No. 591/2008.

²⁶ According to the 1994 Proclamation, “*The purpose of the Bank, by which it shall be guided in all its actions, is to foster monetary stability, a sound financial system and such other credit and exchange conditions as are conducive to the balanced growth of the economy of Ethiopia*”. In the 2008 Proclamation, “*The purpose of the Bank is to maintain stable rate of price and exchange, to foster a healthy financial system and to undertake such other related activities as are conducive to rapid economic development of Ethiopia*”.

²⁷ Including (i) limiting the direct advances to the government to 15 percent of the past 3-year average annual ordinary revenue of the government; (ii) limiting the total amount of (short-term) Treasury Bills purchased and held as security by the NBE and those purchased by banks and other financial institutions to 25 percent of the past 3-year average annual ordinary revenue of the government; and (iii) limiting the total amount of (longer-term) government bonds held by the NBE and by banks and other financial institutions to 50 percent of the past 3-year average annual ordinary revenue of the government.

²⁸ NBE (2017). Annual Report 2016/17.

2.2. State-dominated banking sector

Ethiopia's financial system is mainly limited to a banking sector, which is dominated by one public bank. The financial sector consists of 17 commercial banks and one development bank (DBE), 17 insurance companies, 35 microfinance institutions and 5 capital goods finance companies. The commercial banking industry is dominated by the state-owned CBE. As of June 2018, the CBE accounted for 62.1 percent of total deposits and 71.8 percent of total banking sector credit.²⁹ However, in terms of assets, private banks have gained market share in recent years, from 25 percent in 2005/06 to 36.2 percent in 2017/18.

Private bank development is partly constrained by shareholding limits. No person, other than the government, may hold more than 5 percent of a bank's total shares either on his own or jointly with his spouse.³⁰ In 2011, the NBE raised the minimum paid-up capital required to establish a new bank from birr 75 million to birr 500 million, which effectively stopped the entry of most new banks.³¹ The NBE can also prescribe different capital and reserve requirements to be maintained by different banks depending on the risk profile. The NBE may limit the number of votes by proxy in any meeting of shareholders. It may assign observers to attend any general shareholders' meeting of a bank and even call for such a meeting to discuss and resolve any issues related to the bank.

Private banks' development is also constrained by operational restrictions. Once established, commercial banks should renew their business license every year.³² The appointment (and termination of employment) of the members of the banks' board of directors, chief executive officers or senior executive officers requires the written approval of the NBE. The NBE can "for sufficient cause" suspend or remove a director, a chief executive officer or a senior executive officer of a bank. It also regulates the competency to be fulfilled by directors, the minimum number of directors in the membership of the board of a bank, the duties and the maximum number of years a director may serve in any bank and the conditions for his re-election. The remuneration of private banks' board directors is subject to ceilings set by the NBE. The monthly compensation of directors cannot exceed birr 10,000 (around US\$360) and the annual compensation of members of the board of directors cannot exceed birr 150,000 (around US\$5,400).³³ If banks fail to meet these and other managerial requirements, the NBE can appoint a receiver to take possession and control of a bank.³⁴

The banking sector is closed to foreign participation. Foreign nationals or organizations fully or partially owned by foreign nationals are not allowed to open banks or branch offices or subsidiaries of foreign banks in Ethiopia or acquire the shares of Ethiopian banks.³⁵ Government officials indicated that such foreign entry into the financial sector is not expected to be allowed until domestic banks attain a certain degree of desired competitiveness and the NBE's supervisory and regulatory capacity is adequately strengthened.³⁶ However, Ethiopia has allowed some foreign banks to open liaison offices in Addis, to facilitate credit to companies from their countries of origins. Chinese, German, Kenyan, Turkish, and South

²⁹ NBE 2017.

³⁰ Proclamation No. 592/2008.

³¹ Directive No. SBB/50/2011.

³² Directive No. SBB/56/2013.

³³ Directive No. SBB/67/2018.

³⁴ Proclamation No. 592/2008.

³⁵ Even Ethiopians who want to acquire foreign nationality need to relinquish their shareholding rights at their book values. Proclamation No. 592/2008.

³⁶ Proclamation No. 592/2008.

African banks have opened liaison offices in Ethiopia, but the market remains completely closed to foreign retail banks.

2.3. Mandatory financing of priority projects and directed funding

Private banks are mandated to purchase NBE-bills. To participate in the financing of priority projects, all banks operating in Ethiopia, except the CBE and DBE, are required to purchase NBE-bills in amounts corresponding to 27-percent of their monthly plans of loans and advances disbursement (aka the “27-percent rule”).³⁷ NBE-bills have a maturity of 5 years and, as of December 2018, carry a fixed annual interest rate of 5 percent (3 percent for NBE-bills issued prior to September 2018). The proceeds of NBE-bills purchased by private banks are then partly transferred to the DBE to finance the priority private sector activities and operations of the central government through purchase of T-bills. As of end-December 2018, the outstanding balance of NBE-bills sold to commercial banks reached birr 79.3 billion (with private banks accounting for 99 percent of the total)³⁸ but the amount transferred to DBE was birr 52.1 billion. DBE invested about 58 percent of this borrowing from NBE on government T-bills. Banks may transfer NBE-bills among themselves, may use NBE-bills as collateral for any agreement with a domestic bank or the NBE, and can authorize the NBE to roll over their NBE-bills at the maturity date. However, because NBE-bills carry low yields, they are non-marketable and therefore not traded.

The extent of private banks’ intermediation is constrained beyond standard prudential regulation. To curb the incentives for banks to preserve their working capital from the impact of the 27-percent rule by preferentially extending long-term loans, banks are subject to floors on the share of short-term loans in their assets’ management. A bank’s total outstanding balance of short-term loans cannot be less than 40 percent of its total outstanding balance (excluding NBE-bills outstanding holdings) at any given time. Also, total outstanding balances of revolving credit facilities cannot exceed 10 percent of total outstanding loans and advances at any given time. Though NBE officials state that these restrictions are intended for prudential regulation, the fact that they are introduced with amendments to the 27-percent rule indicates that the prudential regulation motive is not the central motive.

Private banks may also be administratively limited in their credit expansion. The NBE can issue directives to determine the conditions and limitations on investments of banks on loans, advances or other credit facilities, financial guarantees or any other commitments or contracts given by a bank, directly or indirectly to a person.³⁹ Private banks are subject to strict limitations on their extension of loans and advances. For instance, in 2017/18, the NBE limited the outstanding loan growth rate in private banks to 16.5 percent in non-priority sectors—businesses other than export and manufacturing sectors.⁴⁰ Also, the outstanding loans and advances extended by a bank to any one legal or natural person, one related party, and all related parties cannot exceed 25 percent, 15 percent, and 35 percent of the total capital of the bank, respectively.⁴¹ The NBE can prohibit a commercial bank from extending any loan or advance to any

³⁷ Directive No. MFA/NBEBILLS/003/2018.

³⁸ The remaining 1 percent was purchased by the former state-owned Construction and Business Bank, merged with DBE in 2016.

³⁹ Proclamation No. 592/2008.

⁴⁰ Based on a letter sent by the NBE to commercial banks in October 2017.

⁴¹ Directive No. SBB/53/2012.

person on “grounds it may think sufficient”. The NBE can also issue directives to regulate banking businesses related to noninterest bearing deposit mobilization and fund utilization.

As the dominant (public) bank, the CBE is an instrument of the government resource allocation. As mentioned above, the CBE collects the bulk of deposits in the banking system. It also acts as the MOF’s bank and receives almost all government deposits. It is mandated to finance the public sector (i.e., SOEs) as a priority, which explains why the CBE is exempted from the 27-percent rule. In the same vein, the NBE provides to the CBE the foreign exchange shortage to meet the need of each SOE. Both the credit and foreign exchange allocations to SOEs are proposed by the NBE and approved by the Macroeconomic Committee.⁴²

2.4. Administered interest rates

Several interest rates are administered by the NBE. Banks’ minimum interest rates on savings and time deposits are set by the NBE currently at 7 percent per year (banks are free to determine interest rates on demand deposits).⁴³ Because the mandatory interest rate that banks pay on their savings and time deposits is 2 percentage points higher than the interest rate they receive on their mandatory purchase of NBE-bills, which is set at 5 percent by the NBE, commercial banks are subject to mechanical structural financial losses on part of their balance sheet. However, banks are free to determine the lending rate on their loans and advances and can therefore pass the cost of the 27-percent rule and mandatory minimum deposit interest rate to their private sector borrowers.⁴⁴ The inter-bank lending rate is set between the banks concerned. The NBE also exercises moral suasion on the lending rates of the CBE and DBE. Outside the banking system, the NBE and MOF determine the annual yields on T-bills. The NBE also determines the interest rate on the project bonds for the Grand Ethiopian Renaissance Dam (GERD).

2.5. Captive domestic market for government debt

Several public institutions (social security agencies, the DBE and other public institutions) are mandated to invest in government securities.⁴⁵ The NBE acts as the banker and fiscal agent of the government.⁴⁶ In that capacity, the NBE, on behalf of the MOF, conducts weekly auctions of treasury bills (with 28-, 91-, 182- and 364-day maturities) at fixed interest rates ranging from 0.8 percent (28-day bill) to 5 percent (364-day bill). Given their negative real yield, T-bills are non-marketable and unattractive to the private sector. Social security agencies (public and private) are mandated to invest their assets in T-bills. Other captive participants are the DBE on the 364-day maturity segment and other public institutions for the shorter maturities. As of end-December 2018, the outstanding T-bills amounted to birr 125.7 billion (4.7

⁴² The Macroeconomic Committee is chaired by the Prime Minister and comprises representatives from the NBE, the MOF, the National Planning and Development Commission (NPDC), and economic and financial advisors to the Prime Minister.

⁴³ Directive No. NBE/INT/12/2017.

⁴⁴ The lending rates set by the Board of Directors of each bank should be based upon explicit and clear written criteria to be submitted to the NBE.

⁴⁵ According to information from the NBE, none of the T-bill holders can cash their investment upon maturity without approval from the MOF. T-bill holders have no other options but to roll over their bills at maturity.

⁴⁶ Proclamation No. 592/2008.

percent of GDP) with the social security agencies holding 73 percent of the total and the DBE 24 percent. In contrast to its large exposure to domestic public institutions, the government is little exposed to foreign investors, excluding SOE debts. In 2014, the government issued for the first time a Euro-bond, raising US\$1 billion at a rate of 6.625 percent. The 10-year bond was oversubscribed, indicating strong market interest at that time in high-growth Sub-Saharan African markets.

2.6. High liquidity and capital requirements

All commercial banks should maintain liquid assets of no less than 15 percent of their net current liabilities (the sum of demand, savings and time deposits and similar liabilities with less than one-month maturity).⁴⁷ This is in addition to the usual mandatory reserve requirement to maintain public trust and confidence in the banking system, which cannot be less than 5 percent of all birr and foreign currency deposit liabilities held by banks in the form of demand deposits, saving deposits and time deposits. The definition of liquid assets includes mainly cash (foreign and local currencies), deposits with the NBE, deposits with other local and foreign banks, and T-bills. Reserve requirements and liquidity requirements are not remunerated by the NBE. By international comparisons, the level of liquidity requirements is high and onerous in Ethiopia.⁴⁸ All banks must maintain at all times a minimum paid up capital of birr 500 million (around US\$18 million) and a minimum capital to risk weighted assets ratio of 8 percent.⁴⁹ In addition, banks are expected to increase their paid-up capital to birr 2 billion by end-June 2020.⁵⁰ This capital requirement is also high and onerous by international standards for countries at the level of Ethiopia's development.⁵¹

The high rate of liquidity requirements is a mechanism to generate seigniorage revenue. Because mandatory reserves earn no interest and liquidity requirements are in the form of government securities that yield a negative real rate of return, reserve and liquidity requirements function as an implicit tax on banks and restrict banks from allocating a certain portion of their portfolios to productive investments and loans. With the current high requirements, especially on banks' liquidity, banks' lending and borrowing rate spreads must widen to incorporate the amount of non-interest reserves, which, ceteris paribus, reduces the amount of funds available in the financial market. Combined with the 27-percent rule, private borrowers become the main taxpayers as private banks try to recover the loss from the 27-percent rule through higher interest rates than those that would otherwise prevail. Inflation can aggravate the reserve tax, this time on savers, because it reduces the real rates of interest. Thus, high reserves and liquidity requirements make the best use of the government's monopolistic power to generate seigniorage revenue.

⁴⁷ Directive No. SBB/57/2014.

⁴⁸ List of countries and liquidity requirements.

⁴⁹ Directive No. SBB/50/2011.

⁵⁰ A letter from the NBE was sent to commercial banks to that effect in September 2015.

⁵¹ For instance, the capital requirements in neighboring Kenya, Uganda and Tanzania are US\$11.6 million, US\$9.4 million and US\$9.2 million, respectively.

2.7. Strict foreign exchange controls

Ethiopia's national currency is not freely convertible. No person residing in Ethiopia (Ethiopian national residing in Ethiopia and resident foreigners) can hold foreign currency for more than 30 days.⁵² Ethiopian residents entering the country from abroad should declare their foreign currency in excess of US\$1,000 and non-residents in excess of US\$3,000. Foreign currency holdings must be converted into birr through authorized bank branches (forex bureaus). Non-resident Ethiopians and non-resident foreign nationals of Ethiopian origin are allowed to establish and operate foreign currency accounts.⁵³ Authorized banks can open foreign exchange retention accounts for eligible exporters of goods and services and recipients of inward remittances.⁵⁴ However, exporters and remittance recipients must surrender 70 percent of their account balances and convert them into birr after 28 days (30 percent can be kept for an indefinite period). Exporters and remittance recipients can then use their foreign exchange accounts to finance direct business related and current payments such as imports of goods (except vehicles) and related services in relation to business, payments for settlement of external loans and suppliers credit, and other specific payments specified in the directive. Banks in turn are subjected to foreign exchange surrender requirements, equivalent to 30 percent of their foreign exchange inflows, to be surrendered to the NBE monthly at the prevailing mid-exchange rate (simple average of buying and selling exchange rates of the NBE).⁵⁵ Furthermore, the daily overall open foreign currency position of each bank cannot exceed 15 percent of its total capital.⁵⁶

Foreign exchanges are also subjected to strict allocation guidelines. According to the 2016 Transparency in Foreign Currency Allocation and Foreign Exchange Management Directives,⁵⁷ banks are required to prioritize a list of import items and payments in their allocation of foreign currency.⁵⁸ One implication is that banks cannot allocate foreign exchange collected from an exporter to import business of the same exporter outside the priority list. The 2016 Directive was amended in 2017 to include a revised list of essential imports and a new list of items exempted from registration procedures and available on demand.⁵⁹ Once the imports of essential goods are met, banks can then sell foreign currency to their other customers on a first come first served basis. Except for imports by the manufacturing sector, they cannot approve letters of credit (L/C) application without collecting as a minimum 30 percent of the L/C value in cash up front. Banks are required to allocate foreign exchange receipt of an exporter in line with the

⁵² Directive No. FXD/49/2017.

⁵³ Directive No. FXD/55/2018.

⁵⁴ Directives No. FXD/11/1998 and No. FXD/48/2017.

⁵⁵ Directive No. FXD/50/2017 and Directive No. FXD/54/2018.

⁵⁶ Directive No. SBB/23/97.

⁵⁷ Directive No. FXD/45/2016.

⁵⁸ Preferential access to forex is provided for imports of essential goods, (i.e., fuel, fertilizer and other agricultural inputs, pharmaceutical products, factories' requests for procurement of machineries, equipment, spare parts, raw materials and accessories; nutritious food for babies); payments on imports of freight and transit services; payments authorized by the NBE such as foreign loans, suppliers credits, interest, profit, dividend and excess sales of foreign airlines; and salary transfer of foreign employees.

⁵⁹ Directive No. FXD/46/2017.

Retention and Utilization of Export Earnings and Inward Remittance Directives.⁶⁰ They also need to fulfill several additional restrictive regulations in the allocation of forex.⁶¹

Foreign borrowings are also strictly controlled. All private external loans and supplier credits (and their repayments) are subject to NBE prior approval. Exporters and domestic investors are eligible to acquire external loans or supplier's credit provided that the loan/credit finances an export-oriented investment that generates foreign currency.⁶² A domestic investor engaged in projects that generate foreign currency is also eligible to acquire external loans. External loans and supplier's credit conditions are also subject to interest rate ceilings set by the NBE.⁶³ Public external borrowings are subjected to MOF authorization, including from SOEs.

Imports are subject to administered minimum prices. To limit importers' access to the informal foreign exchange market, the NBE introduced a directive on minimum prices and under invoicing.⁶⁴ Before the introduction of this directive, importers used to apply for a small amount of forex from banks and fill the remaining forex needs from the informal market. The importers apply this to get the necessary document from banks to process release of the items from customs. To tackle the issue of under invoicing, the NBE has been distributing price lists of thousands of items to commercial banks. This has led to some adverse consequences. When an importer can get a price below the minimum price set by the NBE, the import cannot be processed. The directive has also been used to compete for scarce foreign exchange. Officials assumed that the issue has been a main factor discouraging remittance senders from using official channels.

3. Effects of financial repression in Ethiopia

A repressed financial system can manifest itself in many ways. As of early 2019, the main effects included a system of fiscal dominance, pressures on inflation, the overvaluation of the birr, a chronic shortage of foreign exchange, the lack of development of the financial system, a credit allocation skewed toward the public sector, and an overall risk of malinvestment.

3.1. Fiscal dominance

The domestic financing of the government has been exclusively financed by the NBE and other captive investors. Government domestic debt has been financed by the NBE, social security agencies and some

⁶⁰ Directive No. FXD/11/1998.

⁶¹ Except for import applications made by the manufacturing sector, banks are prohibited from approving a purchase order without collecting the full amount in birr of the purchase order. Banks are prohibited to issue permit for goods shipped before approval or after expiry of L/C and purchase order. Extension of validity of L/C or purchase order is allowed before the shipment of goods for "good cause". Banks are prohibited to process import applications for approved foreign currency exceeding the period of 15 days from the date of approval. They are prohibited to accept requests on change of items and suppliers after registration of proforma invoice. They are authorized to accept a price increase of up to 5 percent of the registered import value for "good cause".

⁶² Directive No. FXD/47/2017.

⁶³ The all-in-cost ceilings for external loans are 6-month LIBOR plus 2 percent, 3 percent and 5 percent for maturities up to 3 years, 3 to 5 years, and more than 5 years, respectively.

⁶⁴ Directive No. XXX.

SOEs at a far lower interest rate than the market ones. For instance, on average the NBE financed about half of the domestic financing during the last three years at a rate of 3 percent per annum. That is in addition to its financing through the DBE. The minimum deposit interest rate is currently 7 percent and the annual headline stood at 10.9 percent in January 2019. Social security agencies are required to invest their pension receipts on government T-bills at 1.2 percent per annum. Fiscal costs therefore dwarf any other considerations (e.g., macroeconomic stability, resource allocation efficiency) in the authorities' interest rates decision.

3.2. Inflationary pressures

The NBE has become less effective in controlling monetary aggregates and prices. As noted above, a main purpose of the NBE is to maintain stable rate of price.⁶⁵ To achieve this objective in the absence of indirect monetary instruments, the NBE sets the monetary base as a nominal anchor to ensure that its growth remains in line with the projected nominal GDP growth rate.⁶⁶ Given that the NBE does not directly control broad money, the growth rate of base money/reserve money is used as the NBE's operational instrument.⁶⁷ In conducting such a direct monetary control, the robustness of the causal relationship between the instrument (base money) and the final objective (inflation) depends on two key variables: the stability of money demand and the quality of real GDP forecast. First, with the ongoing rapid financial deepening (total deposits of the banking system increased by 28.4 percent in 2017/18), the money multiplier (ratio of broad money to reserve money) has significantly increased over time. It has doubled over the last 7 fiscal years. In September 2018, the money multiplier was 8.6 percent higher than a year earlier. This makes the forecasting of the demand for money in any NBE financial programming exercise quite uncertain, and so the new injection of reserve money consistent with the inflation objective. Second, the forecasting of real GDP growth introduces another major uncertainty in the exercise; especially when the forecasting error tends to be systematically positive. Using data on intensity of light emitted at night as measured by satellites from outer space, it has been estimated that GDP in Ethiopia may have been over-estimated by around 17 percent since 2008.⁶⁸ The combination of these uncertainties and biases has loosened the control of the NBE on broad money growth and ultimately inflation.

Annual inflation increased to 16.8 percent in 2017/18 against a target of 8 percent. Annual inflation accelerated in the aftermath of the October 2017 devaluation and peaked at 16.8 percent in June 2018. It has since decelerated to 10.9 percent in January 2019 as monetary policy was tightened. This was facilitated by some inflation repression. Several goods and services are subject to direct or indirect price controls in the forms of subsidies (e.g., wheat, edible oil, petroleum products), export bans on selected food items (e.g., teff), and public utilities. The Trade Competition and Consumers' Protection Authority is reportedly exercising at times moral suasion when private sector operators decide to increase their sale prices.⁶⁹

⁶⁵ Proclamation No. 591/2008.

⁶⁶ NBE (2009). NBE's Monetary Policy Framework, Economic Research and Monetary Policy Process.

⁶⁷ Reserve money or base money is defined as the sum of currency in circulation and deposits of commercial banks at the NBE.

⁶⁸ McGregor, Thomas (2018). Shining a Light on Ethiopia's GDP. IMF mimeo.

⁶⁹ See the Trade Practice and Consumer's Protection Proclamation No. 685/2010.

3.3. Overvaluation

The NBE has also become less effective in preventing an overvaluation of the birr. While the NBE is mandated to maintain “a stable rate of exchange”,⁷⁰ this objective has been difficult to achieve in an environment of relatively high inflation. According to the NBE, Ethiopia’s annual inflation rate averaged 12.6 percent during the past five years (2012/13 - 2017/18), while the average annual inflation in trading partners was only 4 percent. The rate of nominal depreciation was however too low to prevent a real effective exchange rate (REER) appreciation of some 7 percent during the period. This does not take into account the effects of productivity, terms-of-trade and other shocks that have impacted the equilibrium exchange rate of the birr. According to the IMF, based on data as of September 2018, the external position was assessed to be weaker than the level consistent with medium-term fundamentals and desirable policies, and the exchange rate was estimated to be overvalued by around 12–18 percent.⁷¹ Although the authorities devalued the birr by 15 percent in October 2017, the REER only depreciated by 1.5 percent by end-September 2018. Thus, 90 percent of the benefits of the nominal devaluation were eroded by inflation differentials.

The birr overvaluation contributed to weaken Ethiopia’s external position. Instead of integrating into the world economy, Ethiopia appears to be retracting. The average share of exports and imports to GDP decreased from 20 percent of GDP in 2014/15 to 16 percent in 2017/18. During the period, the trade deficit averaged 17.8 percent of GDP and the current account deficit (excluding official transfers) 8.4 percent of GDP. Although the current account deficit has narrowed during the period, goods exports remained stagnant. In 2017/18, strong growth in air transportation and manufacturing exports (although the latter from a very low base), and continued restraint on public sector capital imports, helped offset stagnant commodity goods exports. Because of this small export base, the 2018 Debt Sustainability Analysis (DSA) shows that Ethiopia remains at high risk of debt distress.⁷² Public and publicly-guaranteed external debt breaches the thresholds for the present value of debt-to-exports and debt service-to-exports in the baseline. Debt service payments are expected to increase in the coming years, as grace periods on non-concessional debt acquired in the past expire.

3.4. Foreign exchange shortage

Foreign exchange reserves have reached critically low levels. By December 2018, the NBE’s net foreign assets were US\$395 million, corresponding to less than US\$4 per inhabitant. According to the IMF, Ethiopia’s foreign reserves are below both rule-of-thumb and model-based optimal benchmarks.⁷³ The gross reserves-to-broad money ratio has trended down since early 2016 and has only rebounded in December 2018 to 14.1 percent thanks to large exceptional external disbursements.⁷⁴ Despite the depreciation of the birr against the U.S. dollar between August 2010 and November 2017, primarily through a series of controlled corrections, including a 20 percent devaluation in September 2010 and a 15 percent devaluation in October 2017, the growth in demand for forex has remained unabated. This was mainly because of insufficient parallel fiscal and monetary tightening. As of December 2018, the official

⁷⁰ Proclamation No. 591/2008.

⁷¹ IMF (2018). Ethiopia: Staff Report for the 2018 Article IV Consultation. IMF, Washington D.C.

⁷² IMF (2018). Ethiopia: Staff Report for the 2018 Article IV Consultation. IMF, Washington D.C.

⁷³ IMF (2018). Ethiopia: Staff Report for the 2018 Article IV Consultation. IMF, Washington D.C.

⁷⁴ These included US\$1 billion and US\$800 million disbursements from the UAE and the World Bank, respectively.

exchange rate was birr 28 per dollar while the parallel market exchange rate was approximately birr 36 per dollar with spikes up to birr 40. Delays encountered by businesses in obtaining foreign exchange for imports, which were in the range of 6 to 8 months, have intensified in 2017/18 to reach more than a year. According to the NBE, between mid-May 2018 and January 2019, banks have received foreign exchange requests worth of US\$7.4 billion but were only able to meet 31 percent of this demand. As a result, the queue for foreign exchange increased by US\$5.1 billion in less than eight months.

The foreign exchange shortage distorts the economy in several ways. Exporters and other operators who have priority access to foreign exchange have incentives to sell their allocations to importers at inflated rates, creating a black-market for dollars, which premium has hovered around 30 percent over the official rate in recent months. Other exporters use their foreign exchange earnings to import consumer goods with high margins rather than re-investing profits in their core business. Slow-downs in manufacturing due to foreign exchange shortages are reportedly common, and high-profile local businesses have closed their doors altogether due to the inability to import required goods in a timely fashion.⁷⁵ Although government policy prioritizes the repatriation of profits in access to foreign exchange, in practice, companies have also experienced delays of up to two years in the repatriation of larger volumes. Partnering with export-oriented companies is a strategy employed by the private sector to address the foreign exchange shortage, but access to foreign exchange remains a problem that can limit growth, interfere with maintenance and spare parts replacement, and inhibit imports of adequate raw materials. The shortage of foreign exchange tends also to fuel the contraband trade through Somaliland because the birr is an unofficial currency there and can more easily be used to purchase products from around the world.

3.5. Underdeveloped and fragile financial system

Ethiopia has one of the least developed financial systems in the world. In the 2018 Global Competitiveness Report, Ethiopia ranked 126 of 140 countries in terms of financial system development.⁷⁶ With total assets of 46 percent of GDP, Ethiopia's financial system is shallow and does not serve well the needs of a transforming economy. Access to finance is identified as the main obstacle to business by 40 percent of firms.⁷⁷ While the share of adults having a bank account has increased significantly in recent years, it remains at a low 35 percent in 2017 (as compared to 43 percent on average in Sub-Saharan Africa). The number of bank branches per capita is low and branches are concentrated in major towns and cities.⁷⁸ Nearly one-third of branches are located in Addis Ababa. The rural poor have little access to formal banking instruments and rely on microfinance institutions (MFIs), informal financing like saving and credit associations, moneylenders and friends. In the absence of formal banking, MFIs have developed and operate a network of around 1,900 branches in September 2018. Some of the biggest MFIs outperform most of the banks in the country in terms of branch network and capital.⁷⁹

⁷⁵ U.S. Department of State, Bureau of Economic and Business Affairs, Investment Climate Statements for 2018.

⁷⁶ World Economic Forum (2018). Global Competitiveness Report 2018.

⁷⁷ World Bank Enterprise Survey (2015).

⁷⁸ Gashayie, A. and M. Singh (2016). "Development of Financial Sector in Ethiopia: Literature Review", Journal of Economics and Sustainable Development, Vol 7, p 9-20.

⁷⁹ For instance, with capital of US\$151 million and a network of 380 branches as of June 2016, Amhara Credit and Saving Institution (ACSI) is more capitalized and has a wider branch network than most of the private banks in Ethiopia.

The existing public banking system is also fragile. Both the CBE and DBE are under increased signs of distress due to potential vulnerabilities emanating from large exposure on CBE's balance sheet to SOEs and high level of NPLs at the DBE. The large exposure of CBE's assets to a single entity – Ethiopian Electric Power (EEP), coupled with unsustainable funding patterns to SOEs poses a significant risk to the financial sector. CBE raises short-term retail deposits to finance long-term infrastructure projects by purchasing SOE bonds (especially from EEP and Ethiopian Railway Corporation) and extending loans to the same sectors. The resulting asset liability mismatch and a high portfolio concentration in specific sectors and enterprises create risks in the system and limit financing to private sector firms. In particular, the interest on EEP bonds that have been purchased by CBE has been serviced by issuing new bonds. In practice, interest has been capitalized, undermining the solvency and liquidity of the bank. CBE is thus acting as a brake on reform of SOEs that have no incentive to restructure as long as the CBE will lend to keep them afloat. The DBE is highly under-capitalized and, a significant surge in NPLs (around 40 percent) puts it at significant risk and will constrain the ability of DBE to serve the credit needs of priority sectors. The DBE is also undermining the NBE's stability objective as the DBE losses are monetized. Given the large concentration of the total banking sector assets in the CBE and DBE, potential instability of these banks will be very costly and will have a spillover effect on other parts of the economy. The size of both state-owned banks makes them SIFI's (systemically important financial institutions), which would require heightened supervisory attention.

The underdeveloped and fragile financial system hinders the development of the private sector. Credit to the private sector did not exceed 12 percent of GDP in 2017/18. The banking sector is highly concentrated in terms of market participants and asset portfolio composition with private banks being crowded-out by government policy that favors the CBE and DBE and the government's extensive financing of large infrastructure projects and SOEs through the CBE. The private banking system provides a limited range of traditional financial products and services with mobile money or other fintech innovations virtually absent. There is no capital market and leasing and insurance remain under-developed. Furthermore, one of the effects of restricting the behavior of existing and potential participants in the financial markets is to create monopoly or captive rents for the existing banks. The scope for diversification into a wider range of financial services that would support private sector development is, therefore, large.

3.6. Skewed resource allocation

The credit market is skewed towards state-owned enterprises (SOEs). In contrast to a decline in overall domestic credit and private credit over the past 10 years, SOEs credit as a percentage of GDP has more than tripled in the last 10 years from 5.2 percent in 2007 to 17.2 percent in 2018. During the same period, the share of SOEs credit in total outstanding domestic credit has surged from 14 percent in 2007 to 54 percent in 2018. In addition to absorbing the larger share of the domestic credit, SOEs also take up over 42 percent (US\$11.2 billion) of the total external debt of the nation (\$26.4 billion) as of end-June 2018. With a policy preference for financing SOEs, the credit market tended to crowd out the private sector. CBE directs a significant portion of its lending to SOEs and use of its retail deposits to purchase bonds in public enterprises that it is lending to; as well as the housing finance scheme that is tied to deposits at the CBE. The large exposure of CBE to a single borrower, the Ethiopian Electric Power (EEP), coupled with unsustainable funding patterns to SOEs, and the recent surge in NPLs of DBE and MFIs poses a significant risk to the financial sector.

It is also skewed toward priority sectors. Financial repression also takes the form of government directives for banks to allocate credit at subsidized rates to specific firms and industries to implement Ethiopia’s industrial policy. As of end-December 2018, the industrial sector accounted for 22.5 percent of the outstanding credit, as compared to 3.2 percent for the agricultural sector, while about 75 percent of the population lives in rural areas. The under provisioning of credit to agriculture could be a factor behind the low productivity of the sector, its vulnerability to weather vagaries, and the occasional spikes of food inflation.

3.7. Risks of malinvestment

Malinvestment refers to the notion that the different dimensions of financial repression often lead to sub-optimal investment decisions, a waste of capital, and eventually economic losses.⁸⁰ The combination of artificially low interest rates, a preferential allocation of credit to government and SOEs, and an unsustainable increase in money supply tends to mislead investment decisions and divert investment from the real long-term needs and demands of the economy. As noted above, The CBE balance sheet is largely exposed to SOEs in general and to the EEP in particular.⁸¹ The DBE’s NPL poses substantial quasi-fiscal risks—as outstanding NBE credit to the DBE represents 2.4 percent of GDP.⁸² Private banks are discretionarily constrained in financing the development of the private sector. Resources invested in NBE-bills are all foregone resources that could have been used in recent years to finance profitable projects and the development of the private sector. In 2017/18, in the absence of the 27-percent rule, private banks could have potentially extended 30 percent more credit to the private sector.⁸³ By end-June 2018, the outstanding amount of NBE-bills held by private banks (birr 71.1 billion) had reached the same order of magnitude as the total loans disbursed by these banks in 2017/18 (birr 67.1 billion). Because of the requirement of the 27-percent rule, private banks are also dissuaded to extend long-term loans to finance potentially more profitable long-term investment projects. Instead, they give preference to short-term finance, such as consumer loans or short-term credit to sectors that are not necessarily the most productive, such as domestic trade.

Another detrimental effect of financial repression can be seen in Ethiopia’s real estate market. Notwithstanding the depressing effects of financial repression on savings, savers are nevertheless looking for ways to shelter their savings from the inflation tax. One way is to invest in the real estate market. The effect of financial repression can then be seen in the proliferation of partially completed office buildings in Addis Ababa and other major Ethiopian cities, leading to real estate price surges. Owners have initiated construction to prevent the government from repossessing the building site but stopped it after two or three stories have been completed because either the additional office space is not actually needed, or the long-term financing required to complete construction is not available.

⁸⁰ The theory of malinvestment belongs to the school of Austrian business cycle theory and was popularized, among others, by Nobel laureate F. A. Hayek.

⁸¹ To map early remedial actions, the NBE has instructed the CBE to undertake an external audit and possibly a comprehensive asset quality review.

⁸² The authorities have undertaken a financial assessment of the DBE and are considering remedial strategies.

⁸³ The total disbursement of loans by the private banks amounted to birr 67.2 billion in 2017/18 while their total purchase of NBE-bills was birr 21 billion.

4. Pathways out of financial repression in Ethiopia

While Ethiopia can learn from (the many) international experiences with exit pathways, it would need to develop its own vision of the transition from financial repression based on its own circumstances. Transitioning from the current Ethiopian financial repression paradigm to one where market forces play a greater role in the allocation of domestic and external liquidities necessarily involves measures to gradually consolidate public finance, overhaul public financial institutions, issue marketable government securities, introduce indirect instruments of monetary control, improve the coordination of fiscal and monetary policies, and correct the overvaluation of the birr.

4.1. International experiences with exit pathways

As noted earlier (see section 1.4), options to exit financial repression are essentially along four dimensions: timing, sequencing, scope and pace. Timing refers to the circumstances or initial conditions best suited to undertake a process of financial liberalization. Countries could strategically decide to orderly graduate and shift away from financial repression as soon as the costs (for instance in terms of real interest rates, distortions, inflation, forex shortage, etc.) appear to outweigh the benefits. Conversely, countries could delay graduation until a major crisis causes an adjustment in a less orderly fashion. The Republic of Korea's experience of the mid-1960s provides an example of having the timing right, which seems particularly relevant for Ethiopia (see Box 3).

Box 3. The Republic of Korea's Liberalization Experience of the Mid-1960s⁸⁴

Back in the mid-1960s, the Republic of Korea's economy shared many characteristics with today's Ethiopian economy, which makes the Korean liberalization experience instructive.

Prior to 1964, Korea had both severely repressed foreign trade and a repressed financial system with ongoing price inflation. Like Ethiopia today, the ratio of goods exports to GDP was very low (less than 3 percent). Almost all foreign exchange earnings originated from official sources (i.e., U.S. military contributions or funds from USAID). These earnings also provided much of the financial saving in the economy because households' financial saving was small. Net inflows of private foreign capital in the financial system were also negligible because foreign bankers considered the repressed Korean economy to be too risky and unprofitable.

In 1964, with the support of USAID, trade and exchange reforms, including some liberalization of imports and a unification of the currency associated with a large exchange-rate devaluation, were implemented, followed by a major financial reform. The domestic capital market, which had been totally moribund, was suddenly brought back to life when interest rates were sharply increased and brought into positive territory in real terms. This was accompanied by a major fiscal reform: no change was made in the tax law, but a different director was put in charge of the tax collection mechanism. Tax revenue doubled in the course of the year. These reforms were appropriately timed. They laid the foundation for Korea's success in subsequent years.

⁸⁴ This box draws on McKinnon (1993).

Sequencing refers to the fact that fiscal consolidation and macroeconomic stability are a prerequisite to financial liberalization and current account convertibility, which is itself a prerequisite to capital account liberalization. Scope refers to the extent to which market forces are allowed to determine the price and allocation of public resources. They can be narrowly limited to certain transactions of the Treasury or widely open to all public sector uses. Another episode in Korea's development during the early 1980s provides an interesting lesson on how to manage key nominal prices (i.e., interest rate, exchange rate, and wages) to avoid serious relative price misalignments in the course of liberalization. The successful price-level stabilization program in 1981-1984 allowed to stabilize the domestic price level, while retaining competitiveness in foreign trade (see Box 4). As a result, Korea's GDP growth and financial development for several years after the program were truly remarkable. The rapid deepening of financial flows within the Korean economy made possible large net repayments of foreign debt through trade surpluses.

Box 4. The Republic of Korea's Price Stabilization Program of the Early 1980s⁸⁵

Like many countries, in the early 1980s, Korea was confronted with high inflation. It decided to implement a price-level stabilization program in 1981-1984 that successfully adjusted the real interest rate to decrease inflation and improve competitiveness, while delaying the full liberalization of the banking system.

During 1979-81, Korea's inflation averaged over 20 percent and its standard nominal loan rates were negative in real terms. With a strong fiscal consolidation and monetary stringency, the inflation rate was drawn down to about 7 percent in 1982 and to 3 percent in 1983. Because of the credibility of the fiscal and monetary programs and overall macroeconomic signaling, the Bank of Korea could quickly reduce the standard nominal loan rate in stages from 20 percent in 1981 to 10 percent by mid-1982, while making it positive in real terms—albeit below market-clearing levels.

Because of tight monetary conditions, central bank credit to commercial banks was constrained and thus was the banks' credit to the private sector. However, because the government's fiscal deficits were simultaneously reduced, the Bank of Korea reduced the banks' reserve requirements and the real flow of loanable funds to the private sector could increase, thus relieving the supply constraint on domestic output. No net credit squeeze on the private sector was necessary once the Korean government and its various special agencies stopped directing the flow of bank credit itself.

The Bank of Korea did not attempt to use its exchange rate as the forcing variable for domestic price-level stabilization. Between 1980 and 1983, the won depreciated a bit faster than the reduction in the domestic inflation rate (to reflect the inflation differential with trading partners). The nominal exchange rate was managed by an informal downward crawl to adjust passively to declining domestic inflation. Foreign capital inflows were limited to secure the desired deflation without significant exchange-rate overvaluation. Thus, as price-level stability was secured, the syndrome of exchange overvaluation was avoided.

The government was however less benign in addressing the difficulties of the banking system. Because of its determination to support the development of domestic heavy industry, the government had coerced the banks into making risky long-term loans in the 1970s—many of which proved nonperforming. In the 1980s, the Bank of Korea still provided subsidized credit lines (i.e., at below

⁸⁵ This box draws on McKinnon (1993).

market rates) to various commercial banks to help them avoid bankruptcy by keeping their old 1970s loans on their books. Into the early 1990s, this overhang of old bad loans continued to hinder the full liberalization of the Korean banking system.

Pace refers to the speed at which the move towards market-based interest rates in the public sector and other liberalizing reforms takes place. It could be swift or phase over a longer period of time. The “shock therapy” corresponds to the situation where market forces are allowed to fully play their role almost overnight in most parts of the economy. It carries the risk of large short-term economic and social costs. The gradual approach corresponds to the opposite situation, where the old economy and new economy continue to cohabit for a longer period of time. It minimizes the short-term costs but carries the risks of reform ineffectiveness, reversal and fatigue leading to an inferior longer-term outcome. In the many transitions experienced in Central and Eastern Europe following the fall of the Berlin wall in 1989, Poland (see Box 5) and the Baltic states are often cited as examples of successful rapid transitions from communism in the early 1990s,⁸⁶ while many other countries’ gradual approach has been less successful.

Box 5. The Polish Shock Therapy of the early 1990s⁸⁷

Poland’s transition to a market economy is generally regarded as one of the most successful experiences among all former socialist countries in Central and Eastern Europe. The success is generally attributed to the initial “shock therapy” administered by then Polish Finance Minister Leszek Balcerowicz to radically and rapidly transition Poland from an economy based on state ownership and central planning to a market-oriented economy. The reforms were implemented at an unprecedented rapid pace. A package of 10 acts (proclamations) aimed at stabilizing and liberalizing the economy was passed by the Polish Parliament and came into force at once on January 1, 1990, barely four months after the establishment of the first post-communist government:

1. Act on Financial Economy Within State-owned Companies, which allowed for SOEs to declare bankruptcy and be sold or liquidated.
2. Act on Banking Law, which forbade financing the state budget deficit by the national central bank and forbade the issue of new currency.
3. Act on Credits, which abolished the preferential laws on credits for SOEs and tied interest rates to inflation.
4. Act on Taxation of Excessive Wage Rise, which aimed at limiting the wage increase in the public sector.
5. Act on New Rules of Taxation, introducing common taxation for all companies and abolishing special taxes that could previously have been applied to private companies through means of administrative decision.
6. Act on Economic Activity of Foreign Investors, allowing foreign companies and private people to invest in Poland and export their profits abroad.
7. Act on Foreign Currencies, introducing internal exchangeability of the złoty and abolishing the state monopoly in international trade.
8. Act on Customs Law, creating a uniform customs rate for all companies.

⁸⁶ Piatkowski, Marcin (2018). *Europe’s Growth Champion: Insights from the Economic Rise of Poland*. Oxford University Press.

⁸⁷ This box draws on Piatkowski (2018).

9. Act on Employment, regulating the duties of unemployment agencies.
10. Act on Special Circumstances Under Which a Worker Could be Laid Off, protecting the workers of SOEs from being fired in large numbers and guaranteeing unemployment grants and severance pay.

While the shock therapy's package came at significant short-term costs in terms of economic contraction, high unemployment and lower income, the economy was on the recovery path just two years into the Balcerowicz Plan. By 1995, Poland was the first Central and Eastern European country to surpass its communist era GDP. One decade after liberalization, Poland had been able to create and nurture a culture of private entrepreneurship, providing jobs and higher standards of living to most Poles. By 2002, Poland had enjoyed the highest growth rate of any post-communist European nation and had become 50 percent wealthier than it was under communism. Poland was also spared the fall in public health levels other reforming nations suffered; unlike its post-Communist peers, Poland did not see the lowered life expectancies that plagued others after revolution.⁸⁸

Poland's success does not mean that its shock therapy approach should necessarily—or can easily—be replicated, especially by developing countries with largely different initial conditions. Prior to its transition, Poland already possessed the public institutions, infrastructure, human development levels and proximity to world markets that were necessary to succeed in the world economy. Unlike many developing nations, the Polish population was educated, literate and experienced in industrial work.

At the same time, Poland, unlike many other Central and Eastern European countries, was able to fully seize the historical moment. As noted by Leszek Balcerowicz, there was also political reasons for radical reforms: the democratic euphoria opened the door for “extraordinary politics”, when it is easier than during normal times to push through difficult reforms.⁸⁹ By making the inevitability of some short-term costs politically acceptable, Polish leaders were able to ensure that the rapid transition to a liberalized market economy would benefit the next generation.

Regardless of scope and pace, coordination is a key ingredient of a successful exit strategy. In the case of Ethiopia, coordination would involve dealing simultaneously or sequentially with the various facets of financial repression described above: (1) consolidating public finances; (2) reforming public institutions; (3) issuing marketable government securities; (4) introducing indirect monetary instruments; (5) improving fiscal and monetary policy coordination and transparency; (6) correcting the overvaluation of the birr; and (7) nudging real undervaluation.

4.2. Consolidating public finances

As noted earlier, a first key prerequisite for a successful exit from financial repression is sound public sector finances. While Ethiopia has a tradition of a relatively sound management of its central government

⁸⁸ Jackson, John E., Jacek Klich and Krystyna Poznanska (2005). *The Political Economy of Poland's Transition: New Firms and Reform Governments*. New York: Cambridge University Press.

⁸⁹ Balcerowicz, Leszek (1995). *Socialism, Capitalism, Transformation*. Central European University Press
Piatkowski, Marcin (2018). *Europe's Growth Champion: Insights from the Economic Rise of Poland*. Oxford University Press.

accounts, with fiscal deficits typically contained to less than 4 percent of GDP, these central government accounts do not include the accounts of state-owned banks, SOEs and other government agencies. Because many of these entities operate with financial deficits, failure to include them in government accounts results in an understatement of the public-sector deficits. According to the IMF,⁹⁰ the net borrowing requirement of the non-financial public sector amounted to 8.6 percent of GDP in 2017/18, of which 3.3 percent of GDP corresponded to external borrowing.⁹¹ A priority in the sequencing of reforms is therefore to prepare consolidated financial accounts that provide a more complete picture of the financial situation of the public sector broadly defined, and pursue the path of public finance consolidation on the basis of the broader definition of the public sector.

Fiscal consolidation of the overall public sector should be pursued to limit the potential macroeconomic destabilization effects of financial liberalization. Because financial repression allows to indirectly finance fiscal or quasi-fiscal operations without collecting the corresponding fiscal revenue, the liberalization of the financial sector will reveal large direct fiscal costs. To maintain macroeconomic stability while liberalizing the financial sector, important efforts would be needed to raise government revenue through tax policy and tax administration reforms, phase out subsidies (e.g., wheat, cooking oil, petroleum), further prioritize public projects, and strengthen SOE governance by hardening their budget constraint. The immediate tax policy measures to consider include the rationalization of tax incentives and exemptions and the strengthening of both the existing presumptive taxation (turnover tax) and excise taxation.⁹² Consideration could also be given to the introduction of property taxes. The hardening of the budget constraint of SOEs will require to dramatically improve public financial management and SOEs' corporate governance, disclosure, and transparency.

4.3. Reforming public financial institutions

Moving away from financial repression would require a series of institutional reforms of Ethiopia's public financial institutions. New or revised proclamations and directives need to be enacted to, among others, (1) strengthen the independence and supervisory functions of the NBE; (2) phase out the 27-percent rule and reform the DBE; (3) design a sustainable financing mechanism for DBE's lending operation; and (4) eventually open the banking sector to foreign participation.⁹³

Strengthening the independence of the NBE from the government. The government should consider amending the NBE Establishment Proclamation to strengthen the NBE institutional, management, and operational independence from the government. There is ample empirical evidence that central bank independence brings about lower inflation, which ensures a more stable environment for economic growth and employment creation. More independent central banks reduce the possibility for governments' interference to monetize their debts or to discretionary channel resources to other publics

⁹⁰ IMF (2018). Ethiopia: Staff Report for the 2018 Article IV Consultation. IMF, Washington D.C.

⁹¹ This borrowing requirement, although high, has substantially declined from 13.7 percent of GDP in 2014/15, owing to stricter controls on SOE operations to contain external imbalances.

⁹² World Bank TA is being provided in these three areas.

⁹³ Other elements of a financial sector reform roadmap would include a new banking act, reform plans of the CBE and DBE, the establishment of a new regulatory framework for the insurance sector, and the development of a stock exchange and corporate bonds market.

sector entities (e.g., SOEs). In recent decades, the principle of central bank independence has been established on a quasi-constitutional basis in many countries, developed and developing alike.⁹⁴ As noted earlier, the 1994 Proclamation establishing the NBE had many provisions guaranteeing more independence than the current 2008 Proclamation. For instance, the NBE advances to the government in the 1994 Proclamation were strictly limited in volume and had to bear market-related rate to be determined by the NBE (Article 25.3.a).⁹⁵ The government should consider re-establishing the principles of NBE independence enshrined in the 1994 Proclamation and strengthening them when relevant; for instance, by imposing a limit on the quantity and duration of advances from the NBE to the government and by eventually phasing them out altogether.

Strengthening NBE's overall regulatory and supervisory function while relaxing its operational controls on private banks. The NBE needs to strengthen its overall regulatory and supervisory functions of the banking system. At the same time, the NBE should relax its controls on private bank shareholders and management and leveling up the playing field between public and private banks. The CBE and DBE boards should be made independent and both banks should be subject to the NBE regulation and supervision like any other financial institution.

Phasing out the 27-percent rule. To support the development of the private sector, the NBE is considering a review of the NBE-bill directives.⁹⁶ Part of the rationale is that, on the one hand, private banks are better equipped today (than when the NBE-bills Directive was introduced in 2011) in terms of capital, human resources and technology to play their role in the financing of the economy, and on the other, the DBE is facing great difficulties to fulfill its mandate as evidenced by the build-up of large NPLs (up to 34 percent by end-June 2019) and the incapacity to fully use the proceeds from NBE-bills. As of end-June 2018, birr 36.8 billion out of the outstanding birr 89.0 billion had not been utilized.⁹⁷ It is therefore time to consider a phasing out of the 27-percent rule and a phase amendment of the NBE-bills Directive (the financial program below proposes a phasing out over three years with a reduction of the allotment ratio to 20 percent in July 2019, 10 percent in July 2020, and its complete elimination in July 2021). The main effects of the phased elimination of the 27-percent rule will be to increase the NBE money expansion, which would need to be mopped-up by the NBE's own monetary instruments, reduce the profits of the NBE and therefore the dividends to the MOF, and increase the profitability of private banks and their capacity to offer lower lending rates to their private sector clients.

Designing a sustainable financing mechanism for DBE's lending operation. Because the DBE is not currently utilizing the full proceeds of the NBE-bills, the first reduction of the allotment ratio to 20 percent will not have any impact on the DBE balance sheet. However, in subsequent years, the DBE would need

⁹⁴ The literature on central bank independence has defined a cumulative and complementary number of aspects: (i) institutional independence (the independence of the central bank is enshrined in law and shields the central bank from political interference); (ii) management independence (the central bank has the right to set its own policy goals, whether inflation targeting, control of the money supply, or maintaining a fixed exchange rate); and (iii) functional and operational independence (the central bank has the independence to determine the best way of achieving its policy goals, including the types of instruments used and the timing of their use).

⁹⁵ Proclamation No. 83/1994.

⁹⁶ NBE (2018). Brief Note on Proposed Amendments to the NBE Bills Directives and Potential Impact (unpublished).

⁹⁷ The existence of unutilized funds (due to the inefficiency of the DBE) has enabled the NBE to finance the government deficit without creating inflationary pressure.

to be reformed to become more efficient and to rely on more sustainable sources of finance. Thus, DBE shall be allowed to mobilize resources either by mobilizing time deposits or by issuing long-term bonds.

Opening the banking sector to foreign participation. Over the medium-term, the financing of the economy would benefit from more modern, diversified and competitive banking services. In connection with the process of WTO accession, which has been reinvigorated, the authorities should envisage a revision of the investment law to allow foreign investment in the banking and insurance sectors.

4.4. Issuing marketable government securities

Supplying marketable T-bills. With or without a formal debt management strategy (see below), the MOF (debt management office) could start issuing marketable government securities. It would need to develop an issuance plan and make tactical choices regarding the instrument, size and timing of the T-bill issuances (see Box 6). Development of such an issuance plan would also be important to attract and retain domestic (and ultimately foreign) investors in the market.

Box 6. Steps in Developing an Issuance Plan for T-bills⁹⁸

The legal, regulatory, and accounting framework governing debt issuance and redemption, and the operational infrastructure, should allow the debt manager to design an issuance plan that enables both the financing of the budget and risk management. The following steps have been identified to develop a government securities issuance plan:

1. Determine financing need to be met by government securities issuance in the domestic market (proportion and weekly breakdown of gross borrowing requirement to be financed with domestic marketable debt)
2. Select instruments: instrument types and tenors (e.g. 6-month treasury bill, 12-month treasury bill, 3-year bond, 5-year bond)
3. Organize auctions: auction size, frequency and sequencing (e.g. bills auctioned every week, 10-year bond auctioned every quarter)
4. Organize maturities (standard maturity months, specific maturity dates)
5. Determine liability management operations (securities and timing of buybacks and exchanges, if any)
6. Develop the auction schedule (timing of each auction, and the instrument and amount to be issued at that auction)
7. Determine the frequency, format, and detail of market communication: announcements (indicative annual auction calendar, more detailed quarterly calendar, more details/adjustments on a monthly/weekly basis), reporting (auction results, monthly and annual reports on issuance plan implementation), consultation (quarterly or monthly meeting with primary dealers and/or other investors, ad hoc consultation before auctions and on special operations)
8. Review and adjustments: periodic (e.g. quarterly, monthly/weekly) review of the issuance plan based on market consultation and updates to the gross borrowing requirement and cash flow forecasting.

⁹⁸ This box draws on World bank (2015). Issuance Plan for Government Securities: Guidance Note. World Bank Group, Washington D.C.

Developing the demand for T-bills from banks and, over time, institutional investors. Private banks should be allowed to participate in the T-bill market and prepare themselves accordingly. Because of the repressed financial environment and the absence of marketable financial instruments, the CBE and private banks have not developed modern treasury operations. They have been coerced to invest in both government securities and SOE bonds without much concern about duration mismatching and interest rate risk. The NBE initiative to develop an active money market and reduce access to central bank financing should encourage the CBE and private banks to develop more sophisticated treasury operations. During a transition period, the auction mechanism (e.g., uniform or multiple price auctions, hybrid system) should be adapted to accommodate the technical difficulties that the banks may face while minimizing the risk of collusion among bidders.⁹⁹ In any case, the CBE should be treated in the same way (i.e., rights and obligations) as private banks. Institutional investors should also be gradually authorized to participate in the government securities market. While the two social security funds will remain captive investors, they should nevertheless be also allowed to invest a growing share of their resources in marketable government securities (see Box 7).

Box 7. Examples of partial liberalization of social security fund investment¹⁰⁰

Because of their role in mobilizing long-term savings, public pension institutions in many developing countries play an important role in funding the government debt. But for various reasons they continue to be treated as captive or semi-captive investors. These include the lack of sophisticated treasury and asset management operations by public sector institutions, the inefficiency of government cash management systems, and political concern about the potential for misuse of the funds of these institutions. At the same time, the misuse of their funds by the governments themselves, forcing them to invest for prolonged periods in non-marketable securities at interest rates that are well below market levels, even below the rate of inflation, constitutes major financial and political risks.

Several countries in Latin America, Central and Eastern Europe, and Southeast Asia have implemented systemic pension reforms in recent years (e.g., the Arab Republic of Egypt, Colombia, Ecuador, Malaysia, Sri Lanka, and Tunisia). These reforms aimed to direct a growing share of their resources into marketable government securities, while making the rates of interest paid on non-marketable securities closer to market levels. Other countries went further and promoted the expansion of supplementary private pension funds. But with the exception of Chile where the reform was implemented in 1981 and has already led to the accumulation of large long-term savings by private pension funds and insurance companies, the reform programs to promote private pension funds are still at an early stage of implementation in many developing countries.

4.5. Introducing indirect monetary instruments

Adopting a new monetary policy framework. So far, the use of indirect monetary instruments by the NBE has been extremely limited due to the underdevelopment of the money market and the virtual non-existence of a financial market for NBE-bills and government securities (T-bills). However, as noted by the

⁹⁹ Vittas, Dimitri (2007). Debt Placement with Public Investors. World Bank. Washington D.C.

¹⁰⁰ This box draws on Vittas (2007).

NBE itself, the introduction of a wider range of monetary instruments should “engender competition, efficiency and transparency and broaden financial intermediation in the banking system.” It also ought to “promote liquidity management of commercial banks and gradually leads to the development of well-functioning money and financial markets, which could serve as catalysts for economic growth and development.”¹⁰¹ The NBE should therefore envisage to use a mix of diversified monetary policy instruments to more effectively carry out its monetary management function. In coordination with the government issuance of tradable securities (see above), the NBE should use open market operations to sale or purchase government securities and its own certificates as the main indirect instruments of controlling liquidity. To prepare the ground for enhanced open market operations, the yield on government securities should be at least close to the minimum saving deposit interest rate—currently 7 percent on annual basis—or targeted inflation rate. As a next step, a secondary market for government securities needs to be established, together with the development of direct borrowing/lending in the inter-bank money market and introduction of a re-purchase agreement (repo/reverse repo operations).

Phasing out administered interest rates. The interest rates on government securities, NBE-bills and associated ones, and SOEs’ borrowing rate from CBE have been set administratively. This policy, which has resulted in a growing mis-allocation of resources, has contributed to the scarcity of resources in the economy and hindered sustainable economic development. Thus, the NBE should consider letting those rates be determined by market forces in the not too distant future.

Phasing out mandatory financing of priority sectors and directed credit. As noted above, the banking system has been financing the priority sectors mandatorily and credit has been directed largely to the public sector. This has been done in two ways in line with the ownership structure of the banks. On the one hand, public banks (CBE and DBE) have been required to allocate resources as per their annual cashflow prepared by NBE and approved by the Macro Committee. Financing needs of SOEs have been the main factors considered in the approval process, in addition to financing capacity of the banks. These allocations have been made based on an administered interest rate structure. On the other hand, private banks are required by a directive to allocate part of their resources to sectors identified by NBE through a below-market interest rate, that is, through the 27-percent rule. The NBE should gradually relinquish its discretionary power on credit allocation and let the market participants make their own choices.

4.6. Improving fiscal and monetary policy coordination and transparency

Improving the coordination between monetary and fiscal policy. The move to more indirect monetary controls would require greater coordination between the NBE and the MOF. The NBE and MOF already decide the amount and tenor of the securities to be issued, considering both the government’s cash requirements and what is required for monetary policy purposes. Moving forward, the two institutions would need to clarify whether NBE transactions in government securities are for meeting the government’s borrowing needs or for monetary policy purposes. The MOF would also need to significantly improve the quality of the forecast of the current and future domestic debt transactions and central government cash flows.¹⁰²

¹⁰¹ NBE (2009). NBE’s Monetary Policy Framework, Economic Research and Monetary Policy Process. Addis Ababa.

¹⁰² World Bank (2013). Debt management Performance Assessment (DeMPA). World Bank Group. Washington D.C.

Enhancing the transparency of government borrowing plans. The move to market-based mechanisms to issue domestic securities would require more transparent communication from the MOF. This would involve the publication of an annual borrowing plan for the aggregate amount of monthly local currency borrowing in the domestic market, divided between the wholesale and retail markets, and the publication of the borrowing plan for T-bills one month in advance with issue dates and instruments. The terms and conditions, borrowing procedures and other modalities for accessing T-bills (e.g., bid tender form) should be accessible on the MOF website consistent with the regulation.¹⁰³ More broadly, the MOF needs to improve its existing debt reporting arrangements. This would include the development of a medium-term debt management strategy to guide the government's annual borrowing plan (see Box 8) and the comprehensive reporting of debt developments, including from SOEs, in the quarterly public sector debt statistical bulletin and annual public debt report, including to inform the periodic review and update of the medium term debt strategy.¹⁰⁴

Box 8. Steps in Developing a Debt Management Strategy¹⁰⁵

A debt management strategy (DMS) should ideally guide the government's annual plan for marketable debt financing. The following steps have been identified to develop a DMS:

1. Identify objectives for public debt management and scope of the debt management strategy
2. Identify the current debt management strategy, and cost and risk of the current portfolio (debt servicing cost, refinancing risk, interest rate risk, foreign exchange risk)
3. Identify and analyze potential funding sources based on relative cost-risk and qualitative factors (multilateral loans, commercial loans, domestic bonds, Eurobonds)
4. Identify baseline projections and risk in fiscal, monetary, and market indicators (projections of exchange rate, capital account, international reserves, expectations of domestic and global liquidity conditions, market rates, and likely pricing of non-market instruments)
5. Review longer-term structural factors (commodity price vulnerability, access to concessional financing, trends in real effective exchange rate and inflation)
6. Assess and rank alternative debt management strategies based on cost-risk trade-off (change in cost and risk indicators, feasibility of the strategy, and success of the strategy in meeting the public debt management objectives)
7. Review the implications of candidate strategies with fiscal and monetary policy, and financial market development (interactions with fiscal and monetary indicators, debt sustainability indicators, and the debt market)
8. Propose a preferred DMS, secure approval for and publish the DMS.

¹⁰³ Directive No. NBE/TRE/001/2011.

¹⁰⁴ World Bank (2018). Ethiopia Growth and Competitiveness Programmatic Development Financing. World Bank Group, Washington D.C.

¹⁰⁵ This box draws on World bank (2015). Issuance Plan for Government Securities: Guidance Note. World Bank Group, Washington D.C.

4.7. Correcting the overvaluation of the birr

Engineering a gradual real depreciation of the birr to eliminate the overvaluation. To restore Ethiopia's external equilibrium, the authorities need to reverse the policy for real appreciation of the birr that has taken place in recent years. Although the birr has depreciated against the U.S. dollar by 6 percent per year on average in the last 5 years in nominal terms, the depreciation has been insufficient to compensate for the inflation differential between Ethiopia and its trading partners. In addition, Ethiopia has been subject to several terms of trade, productivity and other domestic and external shocks that have had an impact on its equilibrium exchange rate—that is, on the real exchange rate that would preserve its external balance.¹⁰⁶ While productivity gains may have played in favor of a more appreciated exchange rate equilibrium,¹⁰⁷ negative terms of trade shocks, such as the sharp decrease in international coffee prices, have played in the other direction. Overall, as noted above, the current overvaluation of the birr is estimated in the 15-20 percent range. Going forward, the authorities need to gradually restore their stock of foreign exchange and stop selling foreign exchange beyond a floor set in the NBE's annual financial program (see below). The exchange rate should then gradually be brought into line with its market clearing level so as to eliminate the administrative allocation of foreign exchange and the parallel exchange market.

Maintaining capital controls to further support the competitiveness of the economy through undervaluation. As noted earlier, the liberalization of the capital account and full convertibility of the national currency constitute the last stage of financial liberalization. These are generally second-generation reforms that are currently premature in Ethiopia. Instead, like many successful developing countries that have adopted export-led strategies in recent decades, especially in Southeast Asia, the (temporary) maintenance of capital controls makes it possible for monetary variables to impact real variables—notably the real exchange rate—and provides a competitive edge in external markets. Because capital controls prevent the domestic private sector from offsetting the public accumulation of foreign assets by borrowing abroad, the accumulation of foreign assets induces “forced savings” in the domestic economy and thereby a real undervaluation of the national currency.¹⁰⁸ In financially repressed financial systems, capital controls are not only necessary to avoid the “overborrowing” syndrome (when the external borrowing of domestic firms builds up too rapidly) but also to limit the risk of inflation (when the domestic money counterpart of foreign inflows grows too fast).¹⁰⁹ Part of China's extraordinary success as a global export powerhouse has been its capacity to constrain domestic consumption and to *ceteris paribus* maintain a real undervaluation of the renminbi for several years in the mid-2000s (see Box 9). In maintaining capital controls and prioritizing the build-up of official reserves in its annual financial

¹⁰⁶ For instance, during 2017/18, global prices of most Ethiopia's major export items dropped, namely those of coffee (10.1 percent), pulses (13.7 percent), and spices (32.4 percent). Meanwhile, fuel import prices increased by 28 percent.

¹⁰⁷ Tica, J. and Druzic, I. (2006). The Harrod–Balassa–Samuelson Effect: A Survey of Empirical Evidence, EFZG Working Paper Series 0607.

¹⁰⁸ Jeanne, Olivier (2012). Capital Account Policies and the real Exchange rate. Working Paper #12-14, Peterson Institute for International Economics. Washington D.C.

¹⁰⁹ As noted in McKinnon (1993), because the governments of repressed economies may consider themselves to be short of foreign exchange on a month-to-month basis, they often behave myopically: they encourage, rather than discourage, inflows of private capital—even though such inflows are artificially stimulated by domestic borrowers trying to evade the domestic inflation tax (p. 104).

programming exercise (see below), the Ethiopian authorities would also give a nudge to domestic savings and therefore conduct a real undervaluation policy that would help boost Ethiopia's external competitiveness. In practice, such policy would require that the NBE sterilizes the accumulation of reserves to avoid any increase in money supply and therefore any internal appreciation of the currency through inflation.

Box 9. The Chinese Undervaluation Experience of the 2000s¹¹⁰

Since the early 2000s, China has regularly been suspected of “manipulating” its currency by accumulating large foreign exchange reserves, maintaining a real undervaluation of the renminbi, and therefore providing a competitive edge to Chinese exports in global markets. In fact, one can distinguish two periods in the Chinese capital account and banking policies in the 2000s.

From the middle of 2003 to the end of 2008, China's financial sector accumulated foreign assets at a high pace, mostly in the form of foreign exchange reserves at the central bank. Total liabilities did not significantly increase during this period (as a share of GDP) because credit to the domestic real sector was reduced to offset the increase in foreign exchange reserves. The Chinese authorities induced forced saving by allocating the Chinese loanable funds to the accumulation of foreign reserves rather than credit to the domestic sector. China's foreign exchange reserves, which had been relatively stable at less than 15 percent of GDP until 2003 began to grow rapidly to reach close to 45 percent of GDP by 2008. To mitigate the impact of reserve accumulation on deposit creation, the central bank issued an increasing amount of sterilization bonds and steadily increased the regulatory cash reserves of banks.

This policy mix was reversed in 2009 when the global financial crisis started. The Chinese authorities started to increase lending to the real sector in an attempt to stimulate the economy. Domestic spending was increased because less loanable funds were used to finance the accumulation of foreign exchange reserves. The ratio of foreign exchange reserves to GDP plateaued at 45 percent of GDP until 2011 before decreasing markedly afterwards to less than 25 percent of GDP by 2018.

This policy course can be interpreted as follows. Throughout the 2000s, China's high rate of economic growth was pulled primarily by the development of its tradable sector. This should have led to an appreciation of the renminbi because of the Balassa-Samuelson effect. However, between 2002 and 2008, because of the existence of stringent capital controls, the Chinese authorities were able to resist an appreciation of the renminbi by accumulating reserves and repressing domestic demand. They stopped doing that and started to stimulate domestic demand once the global financial crisis started. Between 2002 and 2008, the renminbi did not appreciate relative to the US dollar in real terms, whereas the underlying pressure was reflected instead in a booming trade surplus. After 2008, when reserve accumulation slowed down, the trade surplus was reduced at the same time as the renminbi began to appreciate.

Whether the policy of real undervaluation implemented in China and some other Southeast Asian countries during their phase of rapid take-off could be recommended to, and implemented by, other developing countries remains essentially an open empirical question, as well as a political economy question. While a policy of “forced savings” may have a welfare cost by partly depriving the workers from the freedom to consume the fruits of their labor, the policy may also be successful in stimulating net exports, growth and income, thereby offsetting or even overcompensating any welfare loss. Yet, in

¹¹⁰ This box draws on Jeanne (2012).

practice, by definition, not all countries can pursue a policy of real undervaluation at the same time. Beyond the empirical answer, a policy of “forced savings” can only be conducted in a certain political economy context.

5. Transitional macro-financial programming scenario

Implementing the new vision while maintaining macroeconomic economic stability would require solid control over the macro-financial flows and good anticipation on the immediate financial effects. The current NBE financial programming framework would need to evolve and incorporate the main elements of reforms discussed above in new medium-term financial programming. This revised financial program would have significant implications on the financing of the government, the SOEs and the private sector.

5.1. Current NBE financial programming framework

The current NBE monetary policy framework aims at directly controlling monetary aggregates and credit allocations.¹¹¹ This involves several steps. First, given the real GDP growth projection and inflation rate target, the NBE determines the growth of reserve money supply in line with the nominal GDP growth rate. Since the NBE does not directly control broad money, it determines the increase in reserve money consistent with the targeted growth of broad money supply assuming a gradual increase in the money multiplier. Second, based on the balance of payment financing requirements and sources projections,¹¹² the NBE forecasts the net foreign assets (NFA) that would be available in the monetary survey, and by difference with broad money, the net domestic assets (NDA) that could be made available to the economy. Third, the NBE allocates the NDA by prioritizing the credit to the government (direct advances and bonds) and credit to the CBE and DBE based on their respective cash flow needs. The CBE cash flow needs are projected based on the financing requirements of major SOEs.¹¹³ The DBE cash flow assumes that the DBE outflow does not exceed its inflows, which comprises the NBE bills proceeds (27-percent rule), the repayment of its loans, the sale of foreign exchange, and the sale of GERD dam bonds. The remaining NDA represents then the assets available for the CBE and private commercial banks to finance the private sector. Fourth, and in the same vein, the NBE allocates the NFA by prioritizing the foreign exchange needs of the government, the DBE and CBE (including the large fuel import bill) and SOEs, with the remaining balance made available to private banks for the private sector.

The uncertainties surrounding the formulation of the 2018/19 (see Box 10) illustrates the difficulties inherent to any financial programs based on monetary aggregates. As the financial system deepens and becomes more sophisticated, reserve money necessarily loses its effectiveness as a monetary instrument to control broad money growth and inflation. Indeed, in recent years, the growth rate of reserve money

¹¹¹ NBE (2009). NBE’s Monetary Policy Framework.

https://www.nbe.gov.et/pdf/Monetary_Policy_Framework_of_Ethiopia_main_edited.pdf

¹¹² Financing requirements include the current account deficit and the debt amortization (multilateral, bilateral and commercial). Financing sources include net FDI, net disbursements from official external creditors, and net external private sector disbursement.

¹¹³ Ethiopian Electric Power Corporation, Addis Ababa Housing, Railway corporation, Sugar Corporation, Ethiopia Construction Works Corporation, and Ministry of Public Enterprises (Fertilizer complex).

and broader credit and monetary aggregates have diverged. While the NBE could correct the deviations by introducing ad-hoc credit caps, like in 2017/18, such caps have their own inconvenience and are no long-term solution. Instead, the NBE needs to graduate from the current reserve money targeting and move toward more market-based indirect instruments of inflation targeting. The NBE would then achieve its inflation target by raising or lowering interest rates based on whether inflation is above or below its target. Developing such market-based monetary instruments requires the creation of markets for NBE-bills, T-bills, and eventually other securities with market-determined interest rates.

Box 10. The NBE Financial Program for 2018/19 and Its Uncertainties¹¹⁴

The NBE's financial program for 2018/19 is relatively prudent, providing economic growth recovers to its annual GTP II target of 11 percent. It aims at bringing back inflation to 8 percent. Reserve money growth is targeted to decelerate to 13.3 percent (compared to 19.1 percent in 2017/18)—the smallest increase in money creation since 2011/12. With the continued deepening of the banking system, the monetary multiplier is projected to increase by 10.1 percent (somewhat higher than the 8.3 percent annual average growth of the last 5 years). Broad money is therefore expected to expand by 24.3 percent in 2018/19—not too far from the projected nominal GDP growth of 21 percent. The single-digit inflation target would therefore be within reach.

However, the NBE's financial program for 2018/19 would remain inflationary if economic growth does not recover as targeted in the GTP II and the program is not corrected during the year. While remaining significantly higher than the average for Sub-Saharan African countries, Ethiopia's economic growth has decelerated to 7.7 percent in 2017/18 and could remain well below the GTP II target of 11 percent in 2018/19 given the forex shortage and constraint on exports,¹¹⁵ debt overhang, and fragile domestic, regional and global environment. With a GDP growth rate of around 7 percent, the 24.3 percent broad money growth in the current financial program would no longer be consistent with a single digit inflation target. The reduction in inflation achieved during the first half of FY19 could then be compromised.

Whether real GDP growth recovers to its GTP II target or not, the financial program framework will remain relatively uncertain on the economic effects of its allocation of domestic and foreign assets. In the absence of proper price mechanisms (market-determined interest rates), it is difficult to assess the appropriateness of discretionarily providing preferential domestic liquidity and foreign exchange access to the government, the SOEs, and selected sectors.

5.2. Transitional NBE financial programming framework

The NBE monetary policy framework would need to evolve to accompany the process of financial liberalization. The various elements of financial liberalization discussed earlier will directly impact the formulation of the NBE annual financial programming exercise. While measuring with a high degree of precision the possible direct and indirect effects of a financial liberalization reform scenario is elusive, an indicative financial programming framework has been prepared over a five-year horizon (2019/20 –

¹¹⁴ NBE (2018). Financial Program for 2018/19. Mimeo.

¹¹⁵ For instance, the monetary program for 2018/19 assumes that the export of goods would grow by 17 percent, the actual outturn for the first half of the year was a 10 percent decrease.

2023/24) to illustrate the impact of partially and gradually introducing market mechanisms in the formulation of monetary and exchange rate policy (see Box 11).

Box 11. Effects of a liberalization scenario on the NBE financial program for 2019/20 – 2023/24

A tentative financial program has been prepared to incorporate the effects of a partial and gradual liberalization of Ethiopia's financial system during 2019/20 – 2023/24. The reform scenario focuses on the fiscal, monetary and external sector measures. Along with public finance, the SOEs, public banks and social security agencies will be reformed. The scenario does not include other structural and sectoral reforms.

Main assumptions in the baseline scenario:

Real and price developments

- Real GDP growth projected at 7 percent in line with recent performance and the projections of the IMF and World Bank
- Imports of goods and services are projected to grow at around 6.5 percent (on average in US\$ terms) to reflect the ongoing decrease in the ratio of import to domestic credit (from 85 percent in 2015/16 to 63 percent in 2017/18)
- Inflation rate projected at 8 percent over the medium term in line with current NBE policy

Fiscal policy

- Tax revenue of the central government projected to increase slightly over the medium term from 7.8 percent of GDP in 2017/18 to 8.2 percent of GDP in 2023/24
- Direct budget support and relief projected based on data from IMF and World Bank
- Privatization proceeds assume to reduce the outstanding debt of SOEs
- Expenditure of the central government projected constant as a share of GDP to 12 percent of GDP as in the 2018/19 budget
- The fiscal deficit is contained below 3.5 percent of GDP throughout the period
- Net external borrowing of the government grows by 10 percent annually in line with IMF and World Bank projections
- Annual government net borrowing from NBE remains at 1.1 percent of GDP

Monetary and exchange policy

- The nominal exchange rate of birr per US\$ depreciates at the annual rate of 6 percent, consistent with current NBE policy
- Net foreign assets are projected to increase marginally, consistent with the balance of payments projections from the IMF and the World Bank. The NBE reserves accumulate by an average of around U\$300 million per year during the period
- Domestic deposits and credits in commercial banks continue to grow on their current trends (23 percent and 22 percent on average during the period, respectively)
- Broad money grows at a slightly higher pace than nominal GDP based on an estimate of the change in money velocity over time. Money velocity projected to decrease from 3 in 2017/18 to 2.1 in 2023/24
- Commercial bank reserves at the NBE grow in line with deposits and current levels of reserves and liquidity requirements (5 percent and 15 percent, respectively)

- Broad money grows at a slightly higher pace than reserve money based on an estimate of the changes in money multiplier over time. The money multiplier is projected to increase from 4.3 in 2017/18 to 6.2 by 2023/24
- Other items have net growth of 10 percent on average, in line with recent trends in the banks' profits and capital expansion
- Claims on government are growing consistent with the baseline fiscal projections (see above)
- Claims on SOEs are growing by an average of 23 percent in line with recent trends
- Claims on the private sector are calculated as the residual available liquidities and grow at 22 percent

Reform scenario during 2019/20 – 2023/24 predicated on the following changes:

Real and price developments

- Although financial liberalization is expected to stimulate private sector growth and foster GDP growth, the scenario assumes that real variables remain unchanged at least during the projection period, except for imports and exports that are adjusted to reflect the effects of the real depreciation (see below) and the gradual substitution of imports by the private sector's increased access to credit (see below).
- Inflation rate target set at 6 percent (instead of 8 percent), as proposed new NBE policy

Fiscal policy

- The interest rate on all T-bills increases gradually to positive real yield in three years (3 percent in 2019/20, 5 percent in 2020/21, and 1 percentage point above the inflation rate in subsequent years; i.e. 7 percent in 2021/22 onwards)
- The T-bills holdings of the social security agencies and other public institutions are gradually rolled over at the new T-bill rates to reach 100 percent in 3 years (25 percent in 2019/20, 35 percent in 2020/21, and 40 percent in 2021/22)
- The government net borrowing from the NBE is phased out over the period (birr 25 billion in 2019/20 and a reduction of birr 5 billion in each subsequent year to zero in 2024/25). The existing stock of NBE claims on government will not be affected and will remain subject to their current terms and conditions
- The foregone NBE direct advances are financed by T-Bill sales to commercial banks at the new T-bill rates

Monetary and exchange policy

- The overvaluation of the birr is corrected over three years. Assuming a 2 percentage points continued annual price differential between Ethiopia and its main trading partners, the nominal exchange rate of birr per US\$ is assumed to depreciate at the annual rate of 12 percent during 2019/20 - 2021/22. Such a policy is expected to be adjusted in subsequent years consistent with the proposed NBE target of foreign reserves accumulation.
- Net foreign assets of the NBE are targeted to increase gradually, consistent with the impact of real depreciation of the birr and financial liberalization measures. The cumulative additional NBE's NFA could amount to US\$1.6 billion during the 5-year period (i.e., an annual average increase of US\$320 million)
- NBE-bills directive on the 27-percent rule phases out gradually in three years (20 percent in 2019/20, 10 percent in 2020/21, and zero in 2021/22 and beyond)
- Commercial banks are free to participate in the T-bill market

- The reserves and liquidity requirements remain unchanged and the NBE uses its NBE-bills as indirect instrument of monetary control as the 27-percent rule is phased out
- The NBE extension of credit to DBE (currently in the annual amount of birr 10 billion) ends after two years in 2020/21

5.3. Impact on fiscal accounts

The proposed financial liberalization measures will directly impact the central government fiscal deficit (see Table 1). The gradual increase in T-bill rates and phasing out of the NBE advances would increase domestic interest payments on both the existing outstanding stock of T-bills and new T-bill issuances to commercial banks, the social security agencies, and other institutions. By 2023/24, domestic interest payments will be higher by up to 0.7 percent of GDP. The proposed gradual depreciation to correct the birr overvaluation would impact external interest payments by up to birr 790 million in 2023/24. The phasing out of the NBE advances to the MOF will reduce the NBE dividends transferred to the government (with one-year delay). By the end of the 5-year period, the foregone revenue should not exceed birr 4.5 billion or 0.1 percent of GDP. Overall, in 2019/20 (when the reforms are introduced), the fiscal deficit of the central government would be marginally higher than in the baseline scenario (birr 1.5 billion or 0.1 percent of GDP). By the end of the period in 2023/24, the additional fiscal deficit would—everything equal elsewhere—amount to birr 33.1 billion or 0.7 percent of GDP higher than in the baseline.

The impact of financial liberalization on the fiscal deficit points to the importance of implementing concomitant ambitious tax reforms to compensate for the higher costs of government domestic borrowings. A package of tax policy and tax administration reforms should immediately be considered to keep the fiscal deficit below 3.5 percent of GDP (as in the baseline). If the tax to revenue ratio cannot be increased during the period, additional borrowings would need to finance the cost of financial liberalization. The correction of the birr overvaluation would mechanically increase the amount of available external financing denominated in birr, by up to birr 12 billion by 2023/24 or 0.2 percent of GDP. Domestic financing would then need to cover the remaining balance of birr 21.1 billion or 0.4 percent of GDP by 2023/24. Because of the phased-out reduction of the NBE advances to the MOF, the projected domestic borrowing from the commercial banks and social security would then need to increase by birr 71.1 billion or 1.4 percent of GDP.

Table 1: Central Government Finance - Impact of Financial Liberalization Reforms					
	2019/20	2020/21	2021/22	2022/23	2023/24
	Projection				
	(In Millions of Birr, Unless Otherwise Indicated)				
EXPENDITURE	1,523.4	5,783.6	14,800.2	23,715.5	33,126.8
RECURRENT	1,523.4	5,783.6	14,800.2	23,715.5	33,126.8
o/w Additional Cost of the Reform:	1,523.4	5,783.6	14,800.2	23,715.5	33,126.8
Interest Expense (on Existing T-bills Stock)	560.1	1,344.3	2,240.4	2,240.4	2,240.4
Interest Expense (New Issues)	573.4	3,672.2	11,103.2	18,714.7	25,599.3
Fiscal Cost of Devaluation	389.8	467.1	556.6	660.3	787.1
Foregone Dividend on NBE Advances	0.0	300.0	900.0	2,100.0	4,500.0
Overall Surplus/Deficit	-1,523.4	-5,783.6	-14,800.2	-23,715.5	-33,126.8
FINANCING	1,523.4	5,783.6	14,800.2	23,715.5	33,126.8
External net	1,454.5	3,296.0	5,603.2	8,469.3	12,004.8
Domestic borrowing	68.8	2,487.6	9,197.1	15,246.2	21,122.0
Borrowing from NBE	-10,000.0	-20,000.0	-30,000.0	-40,000.0	-50,000.0
Borrowing from CBs (T-bills)	10,000.0	20,000.0	30,000.0	40,000.0	50,000.0
Borrowing from Others	68.8	2,487.6	9,197.1	15,246.2	21,122.0
Memorandum Items					
o/w Additional Cost of the Reform (as % of GDP):	0.1	0.2	0.4	0.5	0.7
Interest Expense (on Existing T-bills Stock)	0.0	0.0	0.1	0.1	0.0
Interest Expense (New Issues)	0.0	0.1	0.3	0.4	0.5
Fiscal Cost of Devaluation	0.0	0.0	0.0	0.0	0.0
Foregone Dividend on NBE Advances	0.0	0.0	0.0	0.0	0.1
Overall Surplus/Deficit	-0.1	-0.2	-0.4	-0.5	-0.7
Financing	0.1	0.2	0.4	0.5	0.7
External Borrowing	0.0	0.1	0.1	0.2	0.2
Domestic Borrowing	0.0	0.1	0.2	0.3	0.4
Borrowing from NBE	-0.3	-0.6	-0.8	-0.9	-1.0
Borrowing from CBs (T-bills)	0.3	0.6	0.8	0.9	1.0
Borrowing from Others	0.0	0.1	0.2	0.3	0.4

Source: Authors' Calculation

5.4. Impact on monetary accounts

The liberalization scenario will also have a major impact on the NBE financial program. To achieve the 6 percent inflation target, the NBE would have to slightly reduce its growth of reserve money. In line with reserve money, broad money growth would also be slightly lower. To achieve a proper accumulation of foreign exchange reserves and increase the import coverage ratio to 2.7 months by the end of the period in 2023/24, the amount of domestic credit available to the economy would therefore be constrained. This would be achieved by gradually reducing the NBE advances to the government and the state-owned banks (CBE and DBE) by up to birr 150 billion in 2023/24. The government would then need to sell T-bills to commercial banks to compensate for the reduction in direct advances. Because of the gradual phase-out of the 27-percent rule, commercial banks would have the liquidity to purchase the government T-bills. Also, the NBE would introduce a lending/borrowing mechanism, such as certificates of deposits or other

securities, to manage the banking sector liquidity in line with its program. The combination of privatization and hardening of the SOE budget constraint would reduce the credit needs of the SOEs. Banks would then be able to extend credit to the private sector in proportion of the efforts made by SOEs to reduce their credit demand.

The CBE would need to operate on a level playing field with other banks and adjust its support to SOEs based on its capacities. With the liberalization, the CBE's access to NBE resources would become tighter and align on the requirements expected from other banks. The CBE would also need to fulfill its liquidity and other NBE requirements.¹¹⁶ At the same time, the CBE should be free to determine the amount of credit and foreign exchange it provides to SOEs based on its own financial capacities, risk-rating and other usual banking criteria. This implies that the NBE or any other government institutions will no longer instruct the CBE on the credit and forex allocations to SOEs.

Private banks are expected to gain in efficiency from the process of financial liberalization. The phasing out of the 27-percent rule would directly benefit the private banks and by extension the private sector. They will be able to participate in the T-bill market and provide financing to the government. They will no longer be discretionarily constrained in their allocation of credit to the private sector (e.g., the 40-60 percent maturity requirement).

Credit to the private sector is expected to continue to expand and support more sustainable economic growth. A consequence of the reforms would be to provide more resources for the development of the private sector for both tradable and non-tradable goods and services. A private credit expansion consistent with price stability could continue at its current pace of 25 percent annual increase during the period. This would require a deceleration of the credit growth to SOEs from about 23 percent in recent years to 15 percent during the projection period. The share of private sector credit in the economy would thus increase from 38 percent in 2018/19 to 48 percent in 2023/24.

The DBE would need to become financially sustainable within 24 months. The phasing out of the 27-percent rule to 20 percent will not affect the DBE in 2019/20 because the DBE has been using less than two-thirds of the NBE-bills proceeds in the recent past. However, starting in 2020/21, the further reduction of the 27-percent rule to 10 percent would become binding on the DBE resources. The DBE has therefore two years to prepare and start implementing a reform plan to become financially sustainable without inflows from the NBE. The outstanding claim of the NBE on the DBE (birr 52.1 billion as of end-June 2019) would also be gradually reduced (by birr 10 billion per year), either by reclassifying them as a claim on the MOF (the current scenario) or written off by the NBE.

¹¹⁶ For instance, as of end-December 2018, while all private banks were fulfilling their 15 percent liquidity requirement, the CBE's liquidity assets ratio stood at 11.9 percent. This amounted to a shortfall of birr 13.6 billion.

Table 2: Monetary Survey - Impact of Financial Liberalization Reforms					
	2019/20	2020/21	2021/22	2022/23	2023/24
	30-Jun				
	Projection				
Foreign Assets (Net)	8,355.8	23,609.8	48,204.6	84,806.1	135,981.4
National Bank	6,220.1	17,875.2	36,907.6	65,436.7	105,501.5
Assets	12,214.7	30,943.4	58,279.5	96,512.9	147,874.9
Liabilities	5,994.6	13,068.2	21,371.9	31,076.2	42,373.3
Commercial Banks	2,135.7	5,734.6	11,297.1	19,369.4	30,479.9
Domestic Credit	-29,319.0	-75,207.1	-142,826.7	-238,031.1	-367,056.0
Claims on Gov't	0.0	-10,000.0	-20,000.0	-30,000.0	-40,000.0
National Bank	-10,000.0	-30,000.0	-60,000.0	-100,000.0	-150,000.0
Government Borrowing	-10,000.0	-30,000.0	-60,000.0	-100,000.0	-150,000.0
Direce advances	-10,000.0	-30,000.0	-60,000.0	-100,000.0	-150,000.0
Gov't bonds	0.0	0.0	0.0	0.0	0.0
Government Deposit	0.0	0.0	0.0	0.0	0.0
Commercial Banks	10,000.0	20,000.0	40,000.0	70,000.0	110,000.0
Claims on Gov't	10,000.0	30,000.0	60,000.0	100,000.0	150,000.0
Treasury bills	10,000.0	30,000.0	60,000.0	100,000.0	150,000.0
Bonds	0.0	0.0	0.0	0.0	0.0
Government Deposit	0.0	10,000.0	20,000.0	30,000.0	40,000.0
Claims on Other Sectors	-29,319.0	-65,207.1	-122,826.7	-208,031.1	-327,056.0
National Bank 2/	0.0	-10,000.0	-20,000.0	-30,000.0	-40,000.0
Commercial Banks	-29,319.0	-55,207.1	-102,826.7	-178,031.1	-287,056.0
By Clients					
I. Public Sector (SOEs)	-32,337.5	-66,465.9	-130,711.5	-235,353.4	-392,689.2
II. Private Sector	3,018.5	11,258.8	27,884.8	57,322.3	105,633.2
Broad Money (M2)	-20,963.2	-51,597.3	-94,622.1	-153,225.0	-231,074.6
Currency Outside Banks	-14,374.4	-33,198.1	-59,409.3	-94,915.7	-141,947.1
Deposits	-6,588.8	-18,399.2	-35,212.8	-58,309.3	-89,127.5
Other Items (Net)	0.0	0.0	0.0	0.0	0.0
Memo:					
Exchange rate (end)	1.7339	3.7798	6.1816	8.9884	12.2560
Net Domestic Assets of the Banking System	-29,319.0	-75,207.1	-142,826.7	-238,031.1	-367,056.0
Imports of Goods and Services (Mlns of Birr)	33,301.6	84,568.6	151,445.2	237,681.6	347,848.5
Gross Official Reserve (Months of Import)	0.1	0.2	0.3	0.5	0.6
Reserve Money (M0)	-4,222.8	-9,817.1	-17,043.9	-26,190.0	-37,566.1
Components: Currency in Circulation	-3,664.9	-8,259.2	-14,062.4	-21,252.8	-30,019.4
CBs Reserve with NBE	-557.9	-1,557.9	-2,981.6	-4,937.2	-7,546.7
Determinants: Net Foreign Assets of NBE	6,220.1	17,875.2	36,907.6	65,436.7	105,501.5
Net Domestic Credit of NBE	-10,000.0	-40,000.0	-80,000.0	-130,000.0	-190,000.0
Net Claims on Gov't	-10,000.0	-30,000.0	-60,000.0	-100,000.0	-150,000.0
DBE Priority Sector Credit	0.0	-10,000.0	-20,000.0	-30,000.0	-40,000.0
Other Items Net of NBE	442.9	-12,307.7	-26,048.5	-38,373.3	-46,932.4
Money Multiplier (M2/M0)	0.0	0.0	0.0	0.0	0.0

Source: Authors' calculation

6. Conclusions and policy recommendations

Ethiopia's framework for managing its monetary and foreign exchange has led to the build-up of large macro-financial imbalances. These include a system of fiscal dominance, pressures on inflation, the overvaluation of the birr, a chronic shortage of foreign exchange, the lack of development of the financial system, a credit allocation skewed toward the public sector, and an overall risk of malinvestment.

Addressing these imbalances requires the adoption of a more market-based macro-financial framework for allocating domestic credit and foreign exchange, including measures to gradually consolidate public finance, overhaul public financial institutions, issue marketable government securities, introduce indirect instruments of monetary control, improve the coordination of fiscal and monetary policies, and correct the overvaluation of the birr.

Implementing the new framework would involve the following key policy changes:

- The NBE inflation rate target is further reduced and the interest rate on all T-bills increases gradually to positive real yield in three years;
- The T-bill holdings of the social security agencies and other public institutions are gradually rolled-over at the new T-bill rates to reach 100 percent in 3 years;
- The government net borrowing from the NBE is phased out over the period; and the foregone NBE direct advances are financed by T-bill sales to commercial banks at the new T-bill rates;
- The overvaluation of the birr is corrected over three years; and the NBE's net foreign assets are targeted to increase gradually, consistent with the impact of real depreciation of the birr and financial liberalization measures;
- The NBE-bills directive on the 27-percent rule is phased out in three years; and commercial banks are free to participate in the T-bill market;
- The reserves and liquidity requirements remain unchanged and the NBE uses its NBE-bills as an indirect instrument of monetary control as the 27-percent rule is phased out; and the NBE extension of credit to DBE ends after two years in 2020/21.

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