Growing an Economy

Impact of Foreign Exchange and Remittances on Ethiopian Development

Tom Keatinge

For any developing country, remittances can be a critical tool, assisting not only with local, grass-roots development but also contributing significantly to a country’s entire economic health. In part, remittances can build foreign currency reserves, address balance of payments deficits, and enable investment in projects involving infrastructure, health, sanitation, and education. Ethiopia benefits tremendously from the support of its diaspora, particularly from its rural population who have migrated in search of temporary employment in the Middle East. Often equivalent to at least 50 percent of the recipient’s monthly income, remittances improve quality of life, enhance health and nutrition, and fund investment in local economies. Although remittances to Ethiopia bring into question existing foreign exchange controls and create possible challenges to the country’s existing anti-money laundering and countering the financing of terrorism (AML/CFT) regime, these funds are undoubtedly positive for the recipients and the Ethiopian economy.

Adequate foreign exchange reserves are an important factor of any well-managed economy. These reserves help cushion the effects of economic shocks, domestic or international. The significance of reserves can be demonstrated by the manner in which countries such as Indonesia are currently dealing with the impact of the U.S. Federal Reserve’s decision to reduce its bond-buying program, used to support the U.S. economy during the recent financial crisis. By building its foreign reserves when it had the opportunity, Indonesia is able to provide vital support to its economy during this current period of stress. In the view of the International Monetary Fund (IMF), Ethiopia’s foreign reserve position is lower than it should be, with the country’s foreign exchange control regime exacerbating this situation as reserves are drawn down to cover the widening current account deficit.2

This brief considers the manner in which foreign exchange control regimes and remittances affect Ethiopia’s economic development and the challenge of imposing
appropriate AML/CFT policies without hindering or limiting the important developmental role played by remittance flows. Although this brief reviews the extent to which these overlapping issues impact Ethiopia’s economic development goals and its evolving AML/CFT regime, Ethiopia is not alone in facing these challenges. Countries in and beyond the region, such as South Africa, Ghana, and Argentina, also use such controls to support and protect their economies and currencies.

**Ethiopia’s Current Foreign Exchange Regime**

Ethiopia achieved notable economic growth while under the leadership of Prime Minister Meles Zenawi, but its foreign exchange controls appear restrictive in comparison to peer group countries. These controls may present the country with complex challenges, such as a widening balance of payments deficit, a shortage of foreign currency reserves, and moribund export growth as it seeks to lead its economy toward “middle income” status consistent with the government’s 2010 “Growth and Transformation Plan (GTP).”

Ethiopia maintains a number of foreign exchange restrictions on payments and transfers that are not consistent with international standards, as determined by the IMF. For example, the Ethiopian birr is not freely convertible because the exchange rates are set by the government. Additionally, Ethiopia limits foreign currency inflows and outflows and the amounts that local and foreign individuals and corporations can hold. These restrictions result in foreign exchange rate appreciation, leading to a widening of the current account deficit. This deficit is further driven upward by the significant imbalance between public capital inflows and moribund export growth, which has been stifled by the strength of the local currency and underdevelopment of private sector banking and manufacturing. In turn, this reduces real income for many workers, with a resulting negative effect on consumer spending. Furthermore, domestic production is suppressed as the strength of the birr allows for the cheap import of substitute goods, reducing domestic production incentives. It would be unfair to lay all these factors entirely at the door of the national foreign exchange control regime, but this policy clearly does not help.

Furthermore, Ethiopia’s foreign exchange reserves have suffered as a result of the National Bank of Ethiopia’s (NBE) strategy of using the sale of foreign reserves to withdraw excess liquidity from the domestic market. It would generally seem more appropriate to achieve this goal via the issuance of government securities rather than deplete an important resource for managing the country’s foreign exchange rate in support of economic growth.

This lack of available foreign reserves is compounded by the government’s rigorous control of foreign exchange movement into and out of the country. The government is pursuing a policy that artificially inflates the value of the birr and hinders investment, economic growth, and development. This is illustrated in comments made in June 2013 by Donald Yamamoto, acting assistant secretary of the U.S. Department of State’s Bureau of African Affairs, when he noted that a shortage of foreign exchange...
discourages U.S. firms and foreign investors from contributing to the Ethiopian economy. Similarly, the IMF asserts that exchange rate flexibility is essential to ensure competitiveness of traded goods, which is critical in reaching the Ethiopian government’s GTP targets.

Another example of the adverse impact of foreign exchange controls on the Ethiopian economy is the extent to which immigrant workers entering Ethiopia from countries such as China are believed to bring foreign currency with them in excess of NBE regulations. Their expenditures drive up the price of goods and services. A more open foreign exchange regime would likely translate into a reduced need for foreign currency to be smuggled into the country. Regional inflation might also be less severe, although high-spending immigrant workers will have an impact on prices in the areas where they live.

Foreign exchange controls may increase money laundering and terrorism financing risks for Ethiopia when individuals, particularly immigrant workers, and businesses seeking to operate internationally need to find alternative means of managing their foreign exchange needs. These alternative means are difficult for the authorities to monitor and track. At a more individual level, foreign exchange controls limit the ability of a population to travel overseas, an important component of international trade and business development that is needed in order to boost a country’s exports and secure the resulting foreign exchange, trade deficit reduction, and overall economic benefits.

The Importance of Remittances to Ethiopia

Remittances are a significant contributor to the Ethiopian economy and can help accelerate the country’s development. IMF data suggest that remittances and official transfers represent more than 4 percent of Ethiopian gross domestic product, with estimates of remittance values ranging from $387 million to $3 billion. This range partly reflects the difficulty in measuring these flows due to the significant use of informal remittance channels as a result of an underdeveloped banking industry and, likely, the tight foreign exchange control regime that the country imposes. It also highlights the size of the potential AML/CFT risk stemming from the significant use of informal value transfer systems.

NBE data indicate that imports surged 87 percent between 2004/2005 and 2007/2008, with half of the required funding for these imports coming from “Private Transfers,” including remittances, whereas less than 20 percent was covered by export earnings. Thus, although these remittances have an important personal value to the recipients, they play a critical role in Ethiopian development.

Another important national aspect to remittance receipts is the positive contribution they could make to the weak national foreign exchange reserve position. The ability of remittances and other transfers into the country to bolster the nation’s financial position
is considerable. Ensuring these flows pass through the formal banking sector is of high, positive value to the national economy.

The country’s foreign exchange control regime risks hindering broad economic development and is likely reducing the value of remittance flows because the overvaluation of the birr corresponds to the undervaluation of foreign currency remittances once they are converted into birr for use by the intended recipients.

One final point to highlight is the importance of data in assessing economic development and the impact of various governmental actions. The collection and analysis by governments of quality economic, demographic, and social data are often key to development. Without reliable, regular, and consistent data collection, it is very difficult for a government to judge the effectiveness of its policies or determine its next actions.

**AML/CFT Considerations**

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

Ethiopia is also the subject of observation from the U.S. State Department. Acknowledging in its 2013 narcotics control strategy report that Ethiopia is not currently a regional financial center due to underdeveloped financial systems and governmental controls such as the restrictive foreign exchange regime, the State Department highlighted that Ethiopia’s central and dominant position within the Horn of Africa means that it is vulnerable to financial activities related to transnational crime, terrorism, and narcotics trafficking. Ethiopia can benefit from the crossroads position it occupies, but as the country becomes more open and continues its economic growth, it is likely that crime related to illicit finance will rise. It is important that Ethiopia prepares itself for the inevitable AML/CFT challenges that will come.

The greatest AML/CFT risk facing Ethiopia is remittance flows, partially encouraged by the structures of the country’s foreign exchange regime, entering the country and the economy via unregulated routes that are difficult for the FIC and other authorities to
monitor and assess. In combination with a private sector banking liberalization process, a less restrictive foreign exchange regime is likely to encourage remittances to flow in greater volume through the regulated financial sector, thus reducing AML/CFT risk.

At the same time, the FIC will need to ensure that the improved standards of training and reporting that it is instilling in banks and their employees are maintained and keep pace with the likely increase in financial volume. In addition, the FIC will need to boost its own capacity to deal with the inevitable rise in CTR and STR filings.

**Summary, Conclusions, and Recommendations**

The Ethiopian leadership and government have delivered growth and progress in recent years. To continue along this successful path, reach middle-income status, and achieve the admirable goals established in the GTP, it must reconsider its foreign exchange controls. This regime has eroded the country’s international economic competitiveness by overvaluing the birr by as much as 14 percent. Without improving private sector access to borrowing capacity and foreign exchange that would create a more favorable business environment, growth will be restricted. The maintenance of strict foreign exchange controls appears to be exacerbating Ethiopia’s current account deficit position, with the birr continuing to be overvalued and with imports continuing to outstrip exports as a result.

Ethiopia has made great strides on AML/CFT issues in developing standards consistent with international guidelines and addressing FATF concerns. Imposing foreign exchange controls, however, is almost certainly leading to the growth of a parallel, unregulated market that has the potential to challenge or reverse much of this notable progress. Together with the underdevelopment of the private banking sector and the extensive flow of remittances into the country, these controls create a potentially significant weakness in Ethiopia’s AML/CFT defenses, something that FATF evaluations can be expected to study closely.

Three key initiatives are recommended. First, the existing foreign exchange regime must be liberalized swiftly. A range of expert bodies have consistently recommended that the current policy is detrimental to the Ethiopian economy and is causing unnecessary challenges for the government as it strives to meet its GTP objectives. The controlled foreign exchange regime exacerbates the flow of funds through channels outside the view of Ethiopian authorities, thus challenging the successful development of the country’s AML/CFT framework.

Second, financial inclusion should be encouraged, bringing financial services access to a greater proportion of the population via an expanded bank network or mobile money. As the Ethiopian economy grows and its banking industry expands, the risks of abuse by illicit finance will increase. The government should ensure that barriers to using the
regulated financial sector are rapidly removed, including greater liberalization of private sector banking and provision of greater access to foreign exchange, removing the need for the current parallel market and reducing the use of informal value transfer networks.

Finally, the importance to the government of the collection and analysis of quality economic, demographic, and social data in determining and judging policies and actions cannot be understated. Working to improve this capability will pay great dividends for Ethiopia, allowing resources and investment to be directed most efficiently and effectively.

Ultimately, the governments of all countries strive to achieve economic growth and provide security. The government of Ethiopia is no exception, but it would greatly enhance its prospects if it allowed broader access to foreign exchange and brought a larger portion of the country’s substantial remittance flows into the regulated financial sector.

Endnotes

3 Ibid., p. 27.
7 Ibid., p. 11.
11 Ibid., p. 12.
Author

Tom Keatinge is a finance and security analyst with 20 years of banking experience working with financial institutions and public sector entities, such as central banks. He focuses in particular on the role played in international security by countering the financing of terrorism and extremism, anticorruption efforts, and economic warfare, including sanctions.

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