TRAIDE

Kingdom of the Netherlands

Forex Guide for Incoming Investors

Ethiopia suffers from chronic foreign currency ('forex') shortages and lacks access to finance. This makes it difficult for foreign investors to operate in the country. With the Ethiopian economy and financial sector only opening to foreign parties in the mid-1990s, Ethiopia is still struggling to ensure the availability of and access to forex. Foreign companies operating in the country face different forex-related issues that can hinder their potential for growth and expansion. However, the situation is expected to improve with the recent decision by the Government of Ethiopia to open up the banking sector to foreign investors as part of its economic reform[1].

This guide is intended to help Dutch newcomers to Ethiopia to understand some of the financial difficulties of doing business in the country and strategies to mitigate them. As the availability of and access to forex is subject to continuous change, we advise Dutch companies to inform themselves about the latest developments by contacting the TRAIDE Ethiopia office or by checking the foreign exchange management webpage of the National Bank of Ethiopia.

Overview of the Ethiopian financial sector

The Government of Ethiopia (GoE) opened the country's first bank in 1905. The State Bank of Ethiopia was established in the 1940s and operated in competition with several foreign banks until all were merged and nationalised under the socialist system in the mid-1970s. The state bank monopolised all economic and commercial activities until as recently as 1995.

In the mid-1990s, the GoE took steps to support the gradual liberalization of the economy and the financial sector. This included introducing new laws and institutions focused on supporting private investment, as the GoE recognized the need for private investment and foreign direct investment for economic development. Liberalization of the financial sector began by allowing the establishment of private commercial banks and insurance companies. Further steps to liberalize Ethiopia's financial (and insurance) sector are currently being made and are expected to materialize in the coming years. These are promising changes that have the potential to address some of the current challenges. Up to the day of writing, Ethiopia's financial sector consists of 29 banks, 18 insurance banks, and 40 microfinance institutions. Of these, only two banks and one insurance company are state-owned.

However, despite its intentions and plans, the GoE has maintained economic control, strictly regulating money, exchange rates and all its transactions through the National Bank of Ethiopia (NBE), which remains the main entity responsible for the monetary and financial sector. The NBE is charged with the task of encouraging economic development by creating an environment of stable prices, forex rates and a healthy financial system.

Over the years, the NBE has periodically devalued the Birr, which had been strictly held at a fixed rate, not aligned to the market value. The controlled exchange rate has had the effect of creating an (illegal) parallel forex market with an increasing gap from the official rate. Since November 2019, the NBE has increased the rate of devaluation at a rapid pace, as per terms set by the International Monetary Fund (IMF). These measures aim to encourage exports and curtail imports, as the devaluation of the Birr against major foreign currencies makes it more expensive to buy imported goods.

[1] The Ethiopian Monitor, available here.

Figure 1. ETB/USD EXCHANGE RATE INCREAMENT-DEVALUATION (%). SOURCE: NATIONAL BANK OF ETHIOPIA, ANNUAL REPORT 2020/21

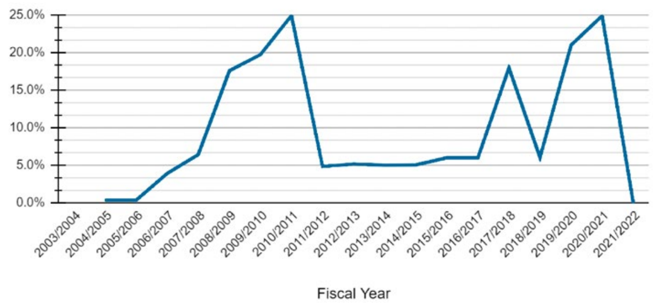
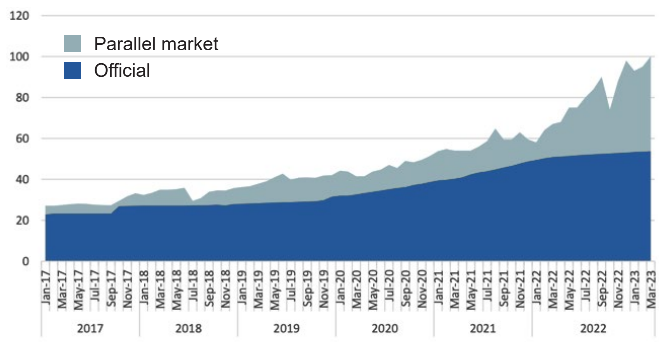
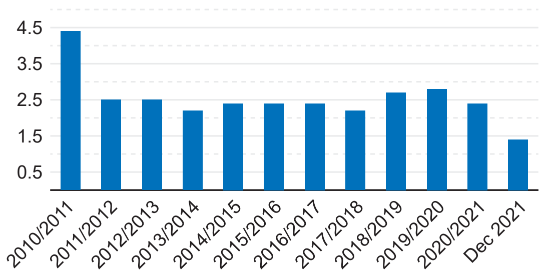


Figure 2. TRENDS OF OFFICIAL AND PARALLEL MARKET EXCHANGE RATE (USD/ETB). SOURCE: NBE (OFFICIAL) AND WFP (PARALLEL)



Nevertheless, the gap between the official exchange rate and the parallel market rate has increased. To illustrate, data from the World Food Programme indicates the official exchange rate in March 2023 was approximately 53.6 ETB per US$1, while the parallel market offered around 95 ETB per US$1.

Figure 3. NATIONAL BANK OF ETHIOPIA'S FOREX RESERVES (MILLIONS USD). SOURCE: CEPHEUS MACROECONOMIC HANDBOOK 2021



Another feature of the Ethiopian economic environment in recent years is its negative trade balance. This chronic trade deficit is usually attributed to low levels of production of exportable goods, logistics difficulties and growing import demands. Ethiopia's foreign currency earnings depend on the export of primary commodities, whose supply and value are not consistent. At the same time, demand for imports has increased over time, thereby increasing the gap between import payments and export earnings.

Factors restricting forex availability

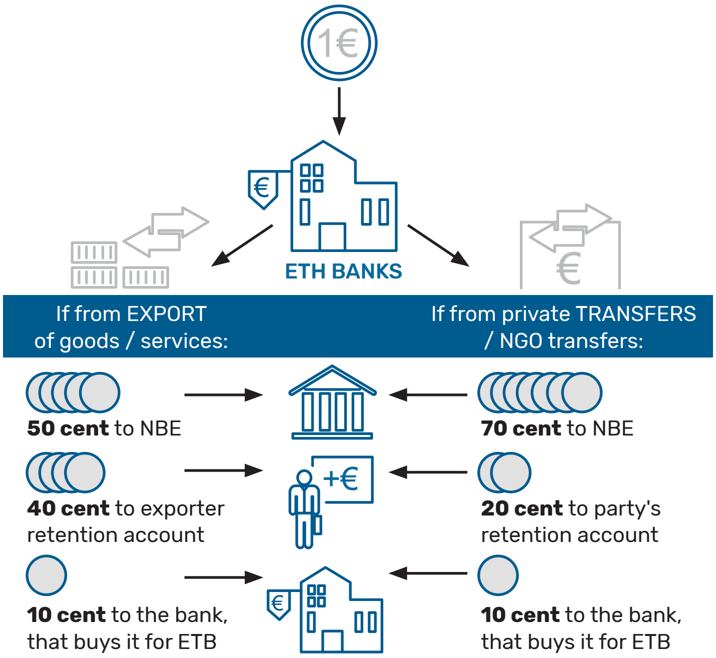
Foreign exchange reserves maintained by the GoE started depleting in 2012 and remain at low levels, representing a longstanding challenge for those seeking to source inputs, goods and machinery from abroad. The decrease in forex reserves has been exacerbated, among other things, by the following factors:

- poor performance of exports in recent years
- internal conflict
- lower external loan disbursements
- growing demand for imports of capital goods
- international debt obligations contracted to fund previously built infrastructure projects
- budgetary support cuts from bilateral and multilateral partners
- increased expenditure on the military, and debt servicing repayments.

Challenges

Directives aimed at fighting the country's forex shortage, such as the former so called '80-20 directive', that required companies to surrender 80% of their foreign currency earnings, dramatically harmed the operations of producer and import substitution companies. Many of them were forced to halt their expansion plans and scale back production. Due to extensive lobbying efforts from diverse stakeholders within the Ethiopian business landscape and persistent pressure from the IMF for the adoption of economic reforms, the Government of Ethiopia has recently introduced a revised directive known as the 'Directive for Amendment of Retention and Utilization of Earnings and Inward Remittances'[2]. This directive allows exporters to retain 40% of their foreign currency earnings. The same directive states that private transfer (remittance) and NGO's transfers recipients can retain 20% of the foreign currency received. In both cases, 10% of the foreign currency is surrendered to the bank that will buy it for birr at the prevailing exchange rate on the day of reception. The diagram on the next page illustrates such movements.

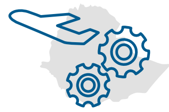
[2] 'Directive for Amendment of Retention and Utilization of Earnings and Inward Remittances' – Directive No. FXD/84/2023, entered into force on August 11th, 2023.



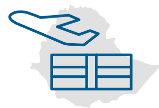
For this to be possible, banks are authorized to open foreign exchange retention accounts for eligible exporters of goods, services and inwards remittances. Those who have not settled their foreign exchange commitments with NBE will be part of a so-called delinquent list and will not be allowed the opening of such account. Foreign currency held in such retention accounts can be used for import of good and services (provided the holder has the required business license) or can be sold for local currency.

Although the above-mentioned steps taken by the GoE to alleviate forex shortages has brought significant relief to the business community, the problem still persists. It is remains difficult for companies to absorb shocks and to plan for viable solutions, but also to expand and grow their business. Companies that generate forex often feel their contribution to the country's forex reserves is not recognized properly.

Furthermore, regulations and interventions do not distinguish between different types of companies, despite the fact that forex requirements differ strongly per company. To illustrate, foreign direct investments are often producer exporters or import substitution companies, who need forex to import inputs for their operations and to make payments to their foreign staff. On the other hand, trader exporters are mostly Ethiopian companies that require less forex as they limitedly engage in production and rarely employ foreign staff. As Dutch companies in Ethiopia are mainly involved in export production or import substitution, they are disproportionately affected by the forex shortage.



PRODUCER EXPORTERS produce and add value in Ethiopia for the export market. They need to ensure high quality standards and hence need high-quality inputs, mostly imported. In principle, most are considered as manufacturing companies and may benefit from priority allocation of foreign currency. Banks also prefer to work with them, as they are exporters and are perceived to have access to foreign currency. However, the lack of foreign currency and high inflation in recent years has meant that even when these companies are successful and make profits, they are unable to repatriate their profits or make payments to their creditors, while their money loses value because of inflation. Some of these companies try to mitigate the problem by reducing their production and halting plans to expand their business.



TRADER EXPORTERS, the majority of whom are local companies, are not involved in value-adding activities or substantial processing. Rather, they collect products (often agricultural produce) and export them. They have limited factories and simple machinery, if any, to do minimal processing, such as cleaning, polishing and packaging items. Most of the labour required is not highly specialised and is available locally. For this reason, trade exporters do not have a strong need for forex and, even with the high surrender requirement from NBE, they end up retaining large amounts of foreign currency.

IMPORT SUBSTITUTION COMPANIES are engaged in production and manufacturing, but instead of exporting their products, they sell them locally. Import substitution companies create jobs and pass on their skills and knowledge to local actors. They also save foreign currency by eliminating the need to import certain materials. Most of these companies need to import raw materials to produce high-quality items that can substitute imported finished products. They therefore require a certain amount of foreign currency. As well as facing similar challenges to producer exporters, companies that exclusively work on import substitution production do not acquire foreign currency. As a result, they are experiencing the most severe shortage of foreign exchange. Such companies often have had to reduce or halt production because they cannot get the raw materials they need. Shareholder loans can help them cope with financial strains resulting from the lack of foreign currency, however, they are still subject to declining profits and strong difficulties in repatriating dividends and repaying shareholder loans. Import substitution companies' relationships with suppliers are at risk, as they're often unable to fulfil their payment commitments because of the lack of foreign currency.

How to reduce your financial risks

Dutch companies planning on entering Ethiopia should organise their forex sources to contrast the challenges illustrated above. You can give your business the best chance of success if:

1. you have long-term investment plans
2. your shareholders do not expect quick returns or yearly dividend pay-outs
3. you require minimum imported inputs and foreign staff (both of which require payment in foreign currency)
4. you have your own source of foreign currency.

Furthermore, the guidelines below will help you reduce your risks and maximise your business potential.

FIRST STEPS

- Understand Ethiopia's financial laws and regulations.
- Evaluate/re-evaluate your company's financial composition and foreseeable forex needs.
- Identify a trusted local party (a consultant, or someone you employ) whose role is to establish relationships with relevant local parties (e.g. banks, ministries).
- Identify the right bank that matches your operations and has experience in your sector of operation – this will save processing times.

COMPANY STRUCTURE AND FINANCING

- Your company structure should facilitate forex influx (e.g. via a sister or parent company abroad).
- If you want to engage in manufacturing, consider entering the industrial park system to benefit from incentives and benefits.
- Consider qualifying for a Strategic Foreign Direct Investment Project, as such projects may be eligible to open an offshore account to deposit the proceeds from their equity and loan financing sources[3].
- Consider taking out a loan from the Development Bank of Ethiopia when you set up or expand your business (and explore other sources of funding, such as equity funds and development partners). This can reduce problems related to accessing finance.
- Use franco valuta[4] permits, for instance allowing a Dutch mother company to send capital goods to its daughter company in Ethiopia.

[3] Directive FXD/86/2023 available here.

[4] Ethiopian Customs guide: 'franco-valuta' refers to the importation of goods without the use of bank method of payment. This method can only be applied under certain conditions.

[5] Directive 67/2020 and amendment in Directive 77/2021 'Transparency in foreign exchange allocation and management'.

OPERATIONS

- Your company can access different benefits by having at least one business (or partnership) in a priority sector. Priority sectors, and hence forex allocation priorities, can change overtime depending on the needs of the country. We recommend checking the updated list on this webpage.

  At the time of writing, the NBE[5] identifies the following:
  - First priority: pharmaceuticals (medicine and inputs for manufacturing of pharmaceuticals and laboratory reagents), input for manufacturing of edible oil, liquified petroleum gas.
  - Second priority: inputs for agriculture (fertilisers, seeds, pesticides and chemicals), inputs for manufacturing (raw materials and chemicals).
  - Third priority: motor oil and lubricants, agricultural inputs and machinery, pharmaceutical products, manufacturing equipment, nutritious baby food, spare parts for construction equipment, education materials.
- Consider export activities to support your non-export business.
- If you're already in the export business, long-term supply contracts can ensure a steady inflow of foreign currency.
- Consider vertical integration to help securing a reliable quality and quantity of inputs for your main production.
- Source inputs locally to reduce forex needs.

RELATIONSHIPS

- Enter into corporate agreements with banks to get preferred customer service – this can result in increased service quality, faster processes and lower processing costs.
- Set up a partnership with a local company that holds import licences so that you can access raw materials at reasonable prices (companies will however charge a premium in Birr).
- Create long-term and solid relationships with input suppliers and try agreeing with them on credit schemes – this can help you alleviate financial pressure and maintain a steady supply of inputs, and hence steady operations.
- Maintain close working relationships with sector-supporting government bodies – this can be beneficial when you are in need of government support.

GENERAL

- Arrange for your company to be represented by well-connected and knowledgeable local individuals who can successfully negotiate on your behalf.
- Be responsive with information and documentation required at the loan appraisal stage, as this will set a good record with the banks, and likely result in easier and faster processes.
- When working with government institutions, be open and transparent in your business transactions, and provide empirical data (evidencing actual value of import substitution, job creation, knowledge and skill transfer, and actual loss resulting from lack of financing) so that the institutions can lobby on your behalf.

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Accessing forex as a Dutch company

When doing business in Ethiopia as a Dutch company, you may need to access forex for different purposes, including:

Import of goods and services	Payments; e.g. salaries of foreign staff	Repatriation of dividends	Repayment of foreign loans

APPROACHES TO OBTAIN FOREX	
Letter of credit	to be obtained from your Ethiopian bank
Forex retention account	can be opened by eligible exporters of goods and services at their Ethiopian bank[6]
Financial instrument	e.g. an Ethiopian importer using forex from a Dutch grant to import goods from a Dutch supplier
Linking to Dutch or foreign NGO programmes	whereby the programme imports goods from the Dutch supplier
Transfer pricing mechanisms	e.g. repayment of loans to the Dutch mother company by internalizing this in the price of products that are exported to the mother company (as per Ethiopian legislation and guidelines).

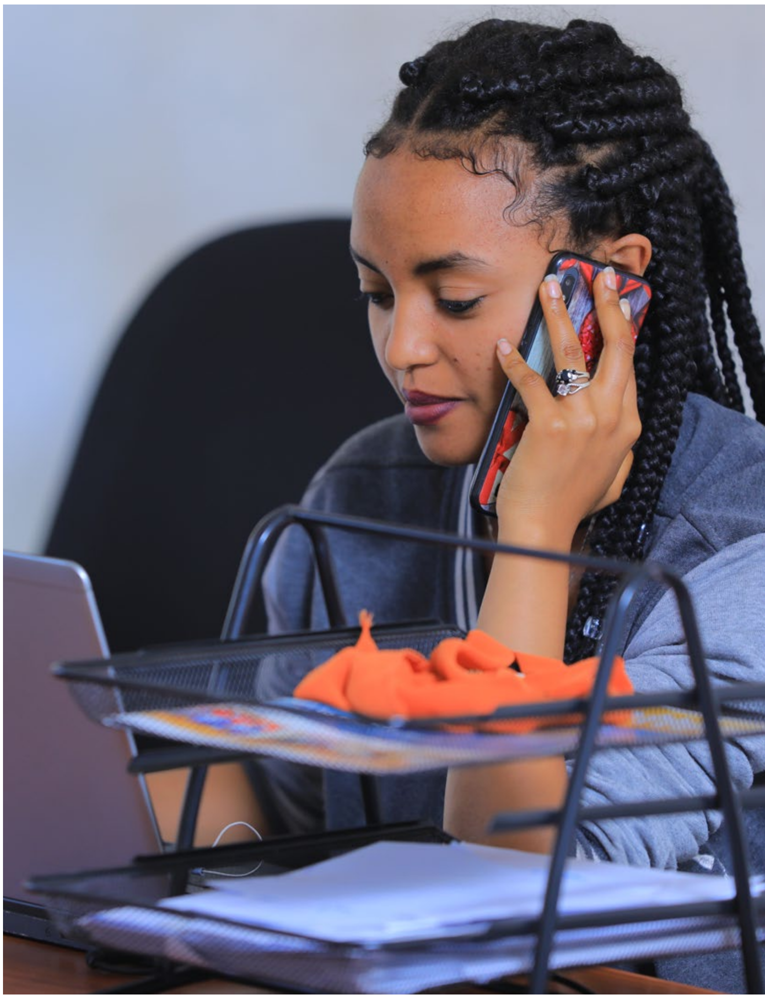
Accessing forex for the repayment of foreign loans and repatriation of benefits can take months and, in some cases, up to years. The duration depends on many factors, for instance whether a company is considered to be in one of the priority sectors of the Ethiopian Government, but also on its experience navigating the Ethiopian business context. Therefore, we advise to account for this in the company's business and financial model and to obtain an in-depth understanding of the local context. Sometimes, working with an experienced financial advisor can prevent issues at a later stage.

[6] Directive FXD/73/2021, available here.

What can TRAIDE do for you?

TRAIDE Ethiopia can support your company to:

- **Access (Dutch) financial instruments:** the Dutch Government and several other international organisations and banks offer different ways to access finance, especially when businesses contribute to the United Nations' Sustainable Development Goals (SDGs). TRAIDE has a database of more than 120 financial instruments and can help you to identify the most suitable instrument for your business.
- **Navigate Ethiopian forex regulations and challenges:** TRAIDE can help you to access local information and we can co-create your business model to ensure it matches the local context and accounts for local challenges.
- **Set up matchmaking services with relevant stakeholders**: our Addis Ababa based team is well connected and can help you to get in touch with the right parties.



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