Causes for Foreign Currency Liquidity Gap: a Situation Analysis of the Ethiopian Economy

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Abstract
The percentage growth of the current account deficit has been diverging through time, mainly explained by the relatively higher growth of the value of imports than the rate at which the value of exports did. Some of the reasons for the current liquidity constraint in Ethiopian case include huge demand for strategic goods (such as petroleum), extended public investment, imported inflation, erratic foreign aid inflow, accumulated and uprising demand of non-strategic imports and poor foreign currency earning capacity. The government of Ethiopia has been committed to enhance the inflow of foreign currency by devising a series of various policy measures including export promotion and diversification, export support schemes, tax holiday, preferential rights for foreign currency and bank credit, loose land lease policy, building industrial zones, awards for model exporters, organizing and coordinating some international markets for domestic goods like a patent right for coffee, flowers and the like which is appreciable and need to be further enhanced.
Keywords: Foreign Currency, Ethiopia, Economy, Liquidity

Introduction

Shortage of foreign currency is one of the characteristics of developing countries. Literature supports the beneficial implications of holding 'a reasonable level 'of foreign assets to fuel the operation of the economy. However there was no definite answer to the optimal size of foreign currency reserves to be held by a country. In fact provides recognition for the explicit variation from country to country depending on the economic situation. In practice, however, most countries often follow the "Rule of Thumb" in determining the optimal level of foreign currency reserves, including maintaining reserves equivalent to at least three months of imports.

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

Economic theory and country experiences tell us that financial capital flows to a country could be linked to increases and decreases in aggregate local investment, domestic savings, the current account balance, output growth and employment, and inflation and asset prices. The effect of capital flows on the real economy depends on the reason for their entry into an economy, and as to how they are used once they arrived. From the balance of payments identity point of view, if a country buys more goods and services from abroad than it sells, the resulting current account deficit should be financed by any one or a combination of the following: borrowing from abroad (a net capital inflow), selling domestic or foreign assets (a net capital inflow) and selling some of its foreign exchange reserves. From the national income identity, a current account deficit means that a country is spending (on domestic investment, and consumption goods and services) more than its national income (GNP). Hence, net capital inflows from abroad would be reflected in domestic consumption plus investment exceeding national income and/or a build-up in net international reserves. So, net capital inflows are associated with either an increase in reserves or an excess of investment over saving (a current account deficit). The right balance between current account and capital flows depends on country's specific factors: the country's debt servicing capacity and whether the inflows are financing investment or consumption.

To manage the flows and stock of foreign currency, as well as to design appropriate policy, it is important to identify the sources and trends in foreign currency inflows to the country. Basically, the standard balance of payment identities that consist of current and capital account balances are being major sources and bases for determining the level of foreign currency reserve holding.

Foreign exchange holdings

The level of net foreign asset holdings has increased at a decreasing rate during the period 2009/10- through

2013/14 with significant fluctuation across the periods..

Table 1: Trends in foreign exchange holdings (in millions of Birr)

Holders	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14
NBE	8,708.7	17,214.6	27,289.3	51,551.4	40,101.40	44,140.0	48,216.5
Commercial Banks	8,026.8	9,219.7	15,060.8	28,394.2	24,017.60	28,518.1	27,253.5
Total Holdings	16,735.5	26,434.3	42,350.1	79,945.5	64,119.00	72,658.1	75,470.0

Source: NBE Annual Report – various issues

Historical records has shown that the country's gross official reserve in 1991/92 was almost nil, equivalent to 1.3 weeks of import. It stood up to 28.3 and 33.1 weeks of import as of June 1994 and 1996, respectively, due to the balance of payment support by foreign donors augmented by the increase in export earnings. But, it exhibited swinging and declined as at June 2002 to cover 4 months of imports of goods and non factor-services of next year. It has been further dwindled to cover respectively only 3.6, 2.3 and 2.2 months of imports as of June 2005, 2006, and 2007, which is almost equivalent to the minimum requirement level of the IMF. The reserve position has dwindled and reached to 8 weeks of import as of 2007/08. Recent year figures also indicated similar fluctuations which reflect the fact that it is one of the challenges that could entangle the country to meet its Development goals. The current level of reserve position, which is closer to the minimum requirement level of the IMF would merely covers strategic goods like petroleum, and hampered the ongoing private investment that set as a pillar for market oriented economy and an engine for growth. In short, the country has concern on adequacy and availability of foreign currency liquidity. The next section gives possible factors as why it is.

Reasons for the Liquidity Gap

The primary need for foreign currency is to finance the demand for imported goods and services. In the Ethiopian case, the percentage growth rate of the current account deficit has been diverging through time, due to relatively higher growth of the value of imports over exports. The likely reasons claimed for the liquidity constraint or foreign currency shortages in the country are given below:

Huge demand for imports of strategic goods and services

The demand for foreign currency has been significantly increasing as import grows faster and higher than exports hence widening trade balance gap. In particular, the foreign currency demand for imports of strategic goods and services like petroleum, education, telecommunication, and defense, as well as imports of metals, fertilizers, and other capital goods was on the high side. Two factors can be cited: the incessant growth in the price of these goods in the international market and the higher import volume of same to the domestic economy for accelerating and sustainable economic development programme.

For instance, previously, the structure of imports was mainly dominated by consumption and manufacturing inputs, but in recent years the highest portion of import value has been fetched by capital and investment goods. The import value share of capital goods has been mounting to 33% in 2013/14, from 20% in 2007/08. During the period 2007/08 through 2013/14, the share of fertilizers and fuel accounted for 21% (with the increase in both volume and price), while consumer goods took 35% of the total import volume due to the higher imports of motor vehicles, cereals, medical and pharmaceuticals and textile fibers.

Table 2: Value of Imports by End Use (in millions of USD)

Items	Fiscal Years						
	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14
Fertilizers	302.1	270.7	249.4	342.4	604.6	291.8	398.9
Fuel	1621.4	1256.6	1310.7	1659.3	2124.8	2163.9	2543.2
Capital goods	1777.4	2474.7	2886.3	2757.0	2961.7	3572.6	4500.3
Consumer goods	1515.7	2383.5	2515.7	2294.8	3531.7	3452.4	3834.1
Total Imports	**8810.7**	**7726.6**	**8268.9**	**8253.3**	**11061.2**	**11467.3**	**13721.9**

Source: NBE Annual Report – various issues

In general, the continuous increase in the international price of strategic goods and services, as well as the increase in imports' volume, due to strong demand has contributed to a strong demand for foreign currency.

Extensive public investment financing

During the period 1992 through 2000, the government's policy prescription was liberalization per se and reduction in public expenditure hence fiscal deficit, allow the private sector to involve both in the real and services sector of the economy as an engine of growth. Accordingly, the public expenditure and thereby foreign currency consumption of the public sector was relatively low. And the mode of deficit financing has been shifted from domestic to external resources. To substantiate this, during the fiscal years 1990/91, 1993/94 and 1994/95 about 25%, 79% and 94% of the fiscal deficits including grants were respectively financed from external sources. This in turn has enabled the government to monitor the inflationary financing and its impact on domestic debt accumulation. However, since 2000, the strategy of the government has shifted from the liberalization paradigm to poverty reduction in the context of Growth and Transformation. In which case, public expenditure has been increasing with the aim of realizing a vibrant Ethiopian economy. Accordingly, foreign currency appetites for infrastructural and social developments like health, electrification, education, and roads have been mounting, that contributes to the depletion of the country's foreign currency reserve that was already limited in size and variety. Besides, following the favourable investment climate created by the market oriented economic policy, private investment in various sectors has been intensified, further aggravating the depletion of the reserve position.

Depreciation in the value of the US dollar

The value of the US dollar has been steadily depreciating (possibly due to slower growth of the U.S economy and a move towards a more portfolio diversification by foreign investors and the sub prime mortgage deterioration) during the recent past. The fact that the US dollar is an intervention currency for Ethiopia and most of the imported goods are often traded in the dollar, depreciation of the dollar may affect the reserve position of the country that in turn brings about the depreciation in the Birr against the US dollar, as importing the same quantity of the goods and services would now require more dollar value than previously. Hence, depreciation of the US dollar could be one of the factors contributing to the reduction of the foreign currency position in real term.

Imported inflation

Historically, the rise in the international price of imported goods, mainly of petroleum, has been one of the major factors to the drawn down of the foreign currency reserve position. For instance, with the relatively consistent growth rate in the volume of the petroleum (6% average growth for the period 2001 to 2007), there has been about a 6.5 fold (38% average growth during the same reference period) change in petroleum prices. This suggests that, almost for the same volume, the imported price inflation due to fuel price hike has highly depleted the reserve position at the cost of other importable goods. In general, the inflation rate of imported goods like fuel, construction materials, fertilizers and their related issues have a significant drawdown effect on the level of foreign exchange reserve. The domestic inflation of exportable items may thinly build up the reserve position as Ethiopian exports lack the required quality, and hence unable to become competitive in the world market for agricultural produces. As a result, Ethiopia remains net importer. The net effects of these combined interactions could rundown the reserve position and intensify the foreign currency liquidity problems.

Nevertheless, recently the recent price reduction of petroleum in the world market was expected to ease the ongoing foreign currency liquidity problem. But, the reality is beyond the expectations for various reasons. Firstly, in the Ethiopian context, fuel price hike is not the only source of the current foreign currency liquidity problem; rather it is a reflection of various economic and policy shocks (mainly a strategy shift towards accelerated and sustainable development programmes that entail huge demand for foreign currency from the aggregate demand). This suggests that the source of the problem could be broad-based economic phenomena. As a matter of fact, there has been extensive public investment in various socio-economic spheres with the aim of realizing the country's vision of reaching the level of middle income countries by year 2020. Hence, the sudden fall in fuel price, mainly associated with the global economic recession, emanating from the financial crisis, might not bring about a significant resolute for the current liquidity problem; rather it gives only a fractional outlet. Of course, amount of foreign currency expended per annum for petroleum financing is huge and the financing has been made at the expense of other sectors' importable goods. To this end, the problem would have been more serious, had the price would remain high. Secondly, though the government has taken unreserved efforts to tackle the ongoing foreign currency liquidity problem, the responsiveness of the real economic sectors for government policies has been sluggish. As many agreed, via running econometric models, the NBE's reaction or the speed of adjustment of feedback effects towards the long run equilibrium (speed of normalization) is 2% per quarter and 8% per annum. On this pace, the adjustment towards long run equilibrium takes many years to achieve full adjustment (Economic inertia effects). Lastly, Unfortunately, the first quarter and early second quarter in Ethiopian economy is not harvesting seasons for major exportable agricultural products so that the current account balance is mostly witnessed a huge deficit relative to other quarters. And, the foreign currency loss incurred due to this seasonality effect would be offset with the foreign currency saved from the decreasing global fuel price (Seasonality effects).

Weak foreign currency earning capacity of the country

As discussed above, there has been upward pressure in foreign currency demand derived from imported inflation, depreciation in the value of the USA dollar, accumulated and uprising demand, investment boom, and economic growth. On the other hand, the permanent source of foreign currency from export earnings is not able to increase at commensurate rate with these ongoing demand hikes, for various reasons. This is because, in long term perspective, Ethiopian export sector as in any developing countries has been characterized by structural bottle necks, low term of trade, and incompetent quality and price at the international market. In addition, despite the efforts to enhance foreign currency earnings from private transfers, it lacks systematic approach that could address the problems inherently associated in this regard. Details are as shown below:

Foreign exchange earnings

The country earns foreign exchange from export of goods and services. The foreign currency earnings from export sector reached to USD 3.9 million as of 2013/14. Even though, it have exhibited a remarkable growth magnitude but dominantly at a decreasing rate, mainly due to inherent structural problems in tradable goods as well as price and demand volatility and stiff competition in the international market.

Similarly, the foreign currency inflow from net service income (mainly from travel, transportation, investment income, and government) has registered a fluctuating performance ranging between USD 74.9 million and USD 559 million during the reviewing period. The major reason for this fluctuating trend could be variability in the country's performance in conference tourism depending on the frequency of international meeting held like China-African Cooperation Forum, Tokyo International Conference for African Development, and the African-Caribbean and Pacific countries, European Union joint parliamentary assembly, the African Union Heads of State, and the Pan African parliamentary. Net-foreign currency earnings from the non-monetary capital account (long-and short-investment) also showed irregular trend depending on the performance records in loan disbursement, amortization, and foreign direct investment..

Table 3: Foreign Exchange Earning Transactions (in millions USD)

Sources	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14
Export earnings	1465.7	1447.4	2003.1	2471.1	3152.7	3081.2	3254.8
Net service income	159.9	384.7	457.5	688.1	74.9	459.1	559.5
Non-monetary capital	968.1	1647.9	1996.2	2473.3	2119.2	3226.4	3901.6

National Bank

Remittance inflows

Remittance is one of the potential and easily accessible sources of foreign currency inflow to the country. The flow of remittances via the formal channel (such as Western Union Money transfer service, Money Gram, etc) has been incessantly growing from USD 723 million in 2008/09 to USD 1.8 billion in 2012/13. This could have been resulted from the enactment by the NBE of a new directive in 2006 and the rise in the number of money transferring agents in particular from Somalia refugees into Ethiopia. The number of Ethiopian citizens residing abroad in known 25 countries is conservatively estimated to reach above 2-3 million, indicating the potential source of foreign currency inflow via remittance.

In sub-Saharan African countries, the inflow of foreign currency through remittance has doubly increased since 2003 and reached USD 10.8 Billion in 2007. Of which, the percentage share of Ethiopia is only 1.6%, that is scanty when compared with the large number of Ethiopians residing in developed and emerging economies mainly the USA, Canada, the Middle East, etc. However, this figure would have been considered, had the amount of foreign currency remitted via informal transmitting channels been added, suggesting the fact that most of the Ethiopian have opted to use the informal channel as they think it is relatively cheap, fast, and reliable transfer service. To this regard, aggressive promotion is required to encourage the Diaspora to remit foreign currency via the formal money transmitting agencies in which Ethiopian banks have entered agency agreement.

Table 4: Flow of remittance (in Millions of USD)

Fiscal Year	2008/09	2009/10	2010/11	2011/12	2012/13
Remittance	723.2	790.3	1,066.4	1,347.5	1,821.9

Source: National Bank of Ethiopia

Foreign aid inflows

Foreign aid is one of the major sources of foreign currency to developing economies. These economies, particularly low income countries, are highly aid dependent to the extent that they could not even function without it. This is because the problem of economic development is highly linked with shortage of capital, as foreign exchange earnings from export business are by far lower than the import demand. Ethiopia is one of these countries, where the flow of aid is required to finance budget deficits to a considerable extent

Table 5: Foreign aid inflows

Particular	Fiscal Years						
	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14
Disbursed Amount	1,684.6	2,091.6	2,584	2,706.7	2,731.6	3,137.9	-

Source: MOFED

Historical witness shows that the inflow of aid to the country was erratic during the past due to local and global political and economic situations, including the global financial crisis. There was a sudden went down of aid commitment (53%) in 2005, which depressed and trapped the economy in fears and compelled the government towards formulating pessimistic expectation about foreign aid inflow. Hence, the government has opted to maintain the on hand foreign currency position from the worst scenario and held up import requests of consumer goods and gave financing priority to strategic goods.

Unrequited export earning income

A rumor goes on to say that some of the foreign direct and domestic investors, in particular those involved in horticulture production, seemingly want to hoard their foreign currency earnings in the importing countries, not to requite back to Ethiopian Balance of Payment in the formal channel. If such tendency continues, it would also adversely affect the foreign currency position of the country, while the government has put a great emphasis on the horticulture industry development.

Accumulated and uprising demand for foreign currency

Following the interruption of the existed foreign aid pattern, and the government's decision to holding up import requests of pipeline investments, the demand for foreign currency that was not entertained during that fiscal year is going to be accumulated through time. This leads the accumulated and the uprising fresh demand for foreign currency moved forward, while the foreign currency holdings moved backward, exacerbating the foreign currency liquidity problem.

Policy interventions

The foreign currency liquidity problem has attracted the attention of the government, banks and the public at large. But, what has the government done to alleviate the problem? Indeed, the government of Ethiopia has been committed to enhance the inflow of foreign currency by devising a series of various policy measures including export promotion and diversification, export support schemes, tax holiday, preferential rights for foreign currency and bank credit, loose land lease policy, building industrial zones, awards for model exporters, organizing and coordinating some international markets for domestic goods like a patent right for coffee, flowers and the like. The government has also adopted other strategies with the view of augmenting the foreign currency earning capacity of the country. With the intention of controlling the shortage of foreign currency from exacerbating, the government (for sometimes) has further attempted to wipe out the parallel foreign exchange markets in Addis Ababa in the sense that the foreign currency being transacted illegally here would be channeled to the formal market. The Monetary Authority (the National Bank of Ethiopia) has also issued a directive for the establishment and operation of Foreign Currency Account for Non-Resident Ethiopians and Non-Resident Ethiopian Origin so as to create incentives and maintains adequate foreign currency reserves, as well as encourages foreign direct investment. Effort is also underway in cooperation with the Ministry of Foreign Affairs to persuade the Diaspora to remit money via the formal money transfer channel, to open foreign currency account herein Ethiopia and invest in Ethiopia. However, there is still a diverge movement between the supply of and the demand for foreign currency (foreign currency constraint), it could be a challenge to effectively realize the envisaged accelerated and sustainable development program. The government action to narrow the gap (which is a very time taking endeavor) in many fronts is appreciable.

Reference

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