St. Mary's University

Department of Business Administration (MBA)

Effect of Foreign Exchange Control on Banks Performance in Ethiopia

By: Firehiwot Taffese

Advisor: Desta Mulugeta (PHD)

A thesis is submitted to Department of Business Administration of St. Mary's University, in Partial fulfilment of the Requirements of Masters of Science Degree in Business Administration

July, 2023

Addis Ababa, Ethiopia

DECLARATIONS

I Firehiwot Tafesse Gabriel, hereby declare that this thesis is my original work and that it has not been submitted partially; or in full, by any other person for an award of academic credential in any other university/Institution.

Submitted by:

Full Name: Firehiwot Tafesse Gabriel, Signature _________________ Date_______________

Approved by:

This Thesis has been submitted for examination with my approval as University supervisor.

Name of Advisor ___Desta Mulugeta (PHD)___ Signature ___________ Date _____________

Name of Co-advisor_______________________ Signature ______________ Date____________

APPROVAL

The undersigned certify that they have read and hereby recommend to St. Marry University to accept the Thesis submitted by Firehiwot Tafesse Gabriel and entitled ***Effect of Foreign Exchange Control and Management in the Performance of Private commercial banks*** in partial fulfillment of the requirement for the award of Master's Degree in Business Administration.

Submitted by:

Full Name Firehiwot Tafesse Gabriel Signature ___________________ Date_____________

Approved by:

Name of Advisor _____________________ Signature______________ Date___________

Name of Co-Advisor____________________ Signature_____________ Date___________

Name of Internal Examiner______________ Signature_____________ Date___________

Name of External Examiner______________ Signature_____________ Date___________

Name of Head of Department________________ Signature__________ Date__________

ACKNOWLEDGEMENT

I cannot thank enough the most Gracious and the most Merciful Almighty God for all things that had happened in my life.

I offer my sincere appreciation for my advisor Dr. Desta Mulugeta for his valuable comments and being there whenever I knock his office. My completion of this project could not have been accomplished without the support of commercial bank officials specially National Bank of Ethiopia.

Finally, to my caring, loving, and supportive friends, your encouragement when the times got rough are much appreciated and duly noted. It was a great comfort and relief to know that you were willing to provide me all the necessary materials and place to sit around and read. My heartfelt thanks!

TABLE OF CONTENT

LIST OF TABLES

LIST OF FIGURES

ACRONYMS

BOP:	Balances of Payment
CBN:	Central Bank of Nigeria
FCY:	Foreign Currency
FDI:	Foreign Direct Investment
FOREX:	Foreign Exchange
FX:	Foreign Exchange
FXD:	Foreign Exchange Directive
GBP:	Great Britain Pound
GOE:	Government of Ethiopia
IFEM:	Inter-Bank Foreign Exchange Market
IMF:	International Monetary Fund
NBE:	National Bank of Ethiopia
NEPC:	Nigerian Export Promotion Council
NEXIM:	Nigerian Export Import Bank
OECD:	Organizations for Economic Cooperations and Development
RDAS:	Retail Dutch Auction System
ROA:	Return on Asset
ROE:	Return on Equity
RSP:	Remittance Service Providers

ABSTRACT

Foreign currency exchange control and management directive have made significant contributions to the overall management of foreign currency in private commercial banks The government takes full ownership of foreign currency, the FX control, as a development strategy, gives a clear indication for financial institution on how to handle their foreign currency allocation and management. This study examined the effects of foreign currency exchange control on performance of banks in Ethiopia. It has mainly focused on newly implemented directive of transparency in allocation of foreign currency and foreign exchange control that has been implemented since 2016. The directive restricts allocation ratio as 10% to medicine, 50% to other priority items and 50% to non-priority item thus, the banks are not allocating foreign currency according to business focuses of the banks. The study applied qualitative and descriptive research approaches. It has included 16 private commercial banks in Ethiopia and 6 years data. As a result, the study has used panel data. Return on Asset (ROA) and Return on Equity (ROE) were used to measure performance of the banks. Allocation of foreign currency to priority and non-priority imports is measured by using percentage of the foreign currency allocated to the imports in a given year. Data was collected from NBE and by using direct interview with bank officers. The collected data was analyzed by using descriptive statistics (Regression, Correlation and others) and econometric estimations. To select appropriate panel model between random effect and fixed effect, Hausman test was conducted and random effect model was selected. This study has identified that foreign currency allocation to priority imports has positive effect on performance of the banks. Therefore, this study recommends management of the banks to allocate foreign currency by strictly addressing the NBE's control mechanism.

Keywords: Foreign exchange control, Foreign Currency Allocation, Priority and Non-Priority Imports, Private commercial banks in Ethiopia

CHAPTER ONE: INTRODUCTION

1.1. Background of the Study

Ever since, the establishment of financial institutions such as banks and insurance companies in Ethiopia, the government doesn't permit foreign currency ownership for the sectors. Ownership right of any foreign currency mobilized in the country is direct right of the government itself. Hence, other financial institutions are only a means to transact the foreign currency via mobilization and other import methods from the country to outside world as well as from outside world to the country. Yet, NBE aiming to foster monetary stability and sound financial system, maintaining credit and exchange conditions conducive to the balanced growth of the economy, it sets foreign exchange control management directives to control the allocation of foreign currency through commercial banks. To this date, different methods are being followed by central bank to control foreign currency allocation system. Therefore, this study will focus on the effect of foreign currency control on the performance of private commercial banks found in the Ethiopia as well as its economic impact shown in the current economic situation of the country. Accordingly, this chapter will includes background of the study, problems statement, methodologies used, objective of the study and scope and delimitation of this study paper.

Most countries, especially developing countries using foreign currency other than their own currency, foreign exchange is needed to transact international trade. Mostly private commercial banks facilitate such type of international trade and also be the intermediary for the foreign exchange transaction channeling. Hence foreign exchange is an important aspect of countries using other currency unit. Transactions done by using foreign currency are executed by using foreign exchange rate set by the government in different developing countries. The foreign exchange rate can also be affected by country economic factors:

- The relative purchasing power of each country's currency
- The investment opportunities and risks of each country and
- The desirability of the goods and services of each country. (www.thismatter.com)

In developing countries many investment opportunities affect the demand of their foreign currency need. Countries with better investment opportunities will attract more capital, which will increase the value of the currencies relative to the countries of the investors. Likewise, increased risks, such as political risks, will cause outflow of capital, reducing the demand for that currency and therefore, its foreign exchange rate. In most country government intervenes in the foreign exchange control and sets exchange rate. In Pakistan, central bank issue licenses of different categories of currency dealership. These dealers perform as a currency trader but also deal in remittances as well. (Mashkoor, 2015)

Though it is repeatedly been stated by scholars that Ethiopia has achieved rapid economic growth since 2014, addressing the major challenges facing the economy is critical to maintaining the growth momentum. Foreign currency earning is one of which the country's economy being affected if not sufficiently being mobilized as well as handled by such institutions. In country's economy institutions are the basic performers. Among the actively players of the country's economy are banks and financial institutions. Banks play prominent intermediation role in the country's economy by facilitating channeling system of foreign and local funds. Healthy financial performance of banks have critical implication for economic growth of a country. This in turn will attract additional investment opportunities that brings economic growth. The country offers several investment opportunities, with its own marketing challenges. However the Ethiopian government (GOE) retains control over most utilities sector. (ITA, 2022). One of which banks being controlled by central bank. For banks to implement good financial performance, it needs to secure profitability. Profitability will only be exercised if enough foreign and local fund is being obtained by banks. Banks performing foreign currency market will enables them to play an important function in society and the global economy. They allow for currency conversions, facilitating global trade (across borders), which can include investments, the exchange of goods and services, and financial transactions. (Nick, 2022) Mostly, the foreign exchange is determined independently to country's economic growth rate. Foreign exchange have an influence on economic growth likewise the economic growth can influence the foreign exchange flow. (Tejvan, 2017)

In our country Ethiopia NBE as a central bank, being the controlling and governing body for financial institutions, it sets rules and regulations that controls the foreign exchange fund management of banks. Different controlling mechanisms are being implemented by the central bank, among which foreign currency allocation and foreign currency management directive. The purpose of setting this controlling rule is due to that foreign exchange is a scarce resource for the country that should be managed carefully to ensure its efficient and proper allocation by banks. (NBE, FXD/45/2016) NBE further in its directive states that there is a need to ensure that foreign exchange is allocated in a transparent and sound manner to priority and other economic sectors without opening a room for rent seeking behavior and malpractice. The force-measure that enforced NBE to set controlling directive is driven by the continuous occurrence of scarcity in foreign currency in the country. The occurrence of foreign currency scarcity becomes more sensitive in handling the imported items. Due this fact the government is using different strategies in handling the foreign currency. Imported items are set to be categorized as priority and non-priority and down to the banning of some products that are considered to be taking much of the foreign currency from the available little resource of the foreign exchange in the country.

1.2. Statement of the Problem

Foreign exchange markets facilitate the trade of one foreign currency for another. Most exchanges are made in bank deposits and involve foreign currency. Businesses, financial institutions, governments, investors, and individuals use the foreign exchange markets to adjust their currency holdings-(FRBS, 2001). Many international exchanges of goods and services are facilitated by the exchange of the currencies of the trading countries. Importers often must obtain the currency of the exporter's country to purchase the goods to be imported. Accordingly, banks play the bigger role in facilitate the foreign exchange for such international trade especially on import and export of goods. In such foreign exchange trade the Bank sector is one of the most essential financial industry. Yet, foreign currency being one of the top and hot agenda of the current Ethiopian economy, having foreign exchange reserve and being competitive enough in the foreign currency mobilization, is the bigger necessitation of commercial banks. This being the case, foreign currency/exchange control set by the government affects the performance of banks as well as it helps to control the misuse in resource allocation.

In today's Ethiopian economy and foreign exchange reserve of the country, FX reserves maintained by the government remain at low level. The decrease in foreign exchange reserves and the foreign exchange shortages due to weak export performance and high demand for foreign currency will continue to present significant market challenges, particularly for potential importers in the country-(Minhaj & et al, 2020). The shortage in foreign currency is being critical to the country, hence the NBE's regulations on FX allocation and management require private commercial banks to allocate foreign currency to importers based on the priorities laid out in the Growth and Transformation Plan (GTP II). In addition to the control regulation of FX allocations banks are forced to surrender 70% of the foreign currency generated to the government and utilize the rest 30% for import and other overseas transactions. This led the black market to be more practiced around banks even on remittances send to the country are now being massively exercised in black market rate.

The 30/70 surrender regulations has led to the discouraging fact on Ethiopian exporters. Less export and more import are now being exercised which led the higher demand for foreign currency that is greater than the supply. The more the demand increases the more banks allocation and their open position is affected and leads to failure in undertaking their commitment. This commitment failure is also being observed recently on private commercial banks in the country. The FX allocation regulation that is being exercised by the private commercial banks have led them to exercise low business interest rate as well as affecting their customer relationship badly-(Asrat, 2021). But on the other hand there are debates that working on priority area of the economy boosts economic growth and ultimately results on strong performance of private commercial banks (Hommel 2008, as cited in Asrat, 2021).

Different studies were conducted on the effect of foreign exchange, which mostly express about FX exchange rate and countries devaluation effect on their economic growth. Most of the studies conducted in the country also talks about devaluation, and exchange rate fluctuations. The recently conducted research by Asrat (2021) were focused in FX exchange allocation control and management. To the knowledge of the researcher there are no other studies conducted to identify the effect of foreign exchange allocation control in private commercial banks and their performance. Hence, this study is as well conducted to show the effect of the current foreign exchange allocation control on performance of private commercial banks up to the most recent times where the severity of the foreign currency is most sensitive agenda of the government and private banks mechanisms of FX management.

1.2.1. Research Gap

In the aforementioned part of this paper through discussion on, different studies were conducted to identify effect of foreign exchange control on performance of commercial banks. But these studies mainly focused on effect of exchange rate. Few studies were conducted to identify effect of rationing of foreign exchange on performance of commercial banks. To the knowledge of the researcher there is no any study conducted to identify the effect of foreign exchange control and its management via private commercial banks in Ethiopia. Therefore, this study was conducted to identify the effect of foreign exchange control and its management on performance of private commercial banks in Ethiopia by using foreign currency allocated to priority imports and non-priority imports.

1.3. Objective of the Study

1.3.1. General Objective of the Study

The general objective of the study is to analyze the effect of foreign exchange allocation control on performance of private commercial banks in Ethiopia and their FX management system.

1.3.2. Specific Objective of the Study

- To show how the private commercial banks exercise the foreign exchange allocation regulation
- To determine the effect of the foreign exchange allocation control on private commercial banks performance and their FX management system.
- To explain the foreign exchange allocation and management effects on the overall country economy and its direct effect on banks profit making.
- To show the effect of the FX allocated by private commercial banks on priority items
- To investigate how private commercial banks exercise FX allocation to non-priority items.

1.4. Basic Research Questions

In order to achieve both general and specific objectives stated above the research will raise the following basic research questions:

- How do private commercial banks in the country manage, implement the FX control regulation for priority and non-priority items?
- What does the currently existing performance of private commercial banks in Ethiopia look like?
- To what extent does foreign exchange allocation/control (to priority and non-priority sectors) affect performance of private commercial banks in Ethiopia?

1.5. Significance of the Study

The issue of foreign currency allocation attracts so much attention in Ethiopia, discussions surrounding it mainly focus on the availability of the FX resource and are generally without any reference to overall economic activity. This in turn will generates the idea of discussing to the governments FX allocation control system and the role of exchange rate management for promoting economic growth and maintaining healthy business transactions. Hence, the objective of this study is to analyze the effect of foreign exchange control on performance of private commercial banks in Ethiopia and their FX management system. It is expected that the result of this study will contribute to current knowledge of exchange control effects on the performance of private commercial banks in the country.

This study will provide adequate information for all stakeholders in foreign currency allocation system. The study result can be a potential input for the bank management to devise strategy that can help to optimize gain and losses that originate from foreign exchange control. The study result may also be a useful input for bank regulators and supervisors to induce private commercial banks to have proactive exchange rate risk management strategy that encompasses both the direct & indirect impact of exchange control on banks profitability.

The study can also paves a way to other researchers to undertake their research on FX allocations as well as the FCY scarcity that is being observed in the country and its effect on the performance of the current working private commercial banks as well and the emerging local and foreign financial institution in the country. Finally, this study will be of use full for future researchers as a reference for those looking to investigate the performance of private commercial banks during their research conducting period and it will also be useful to show future researchers on how the FX allocation control had affected other stakeholders and the county's economy in general.

1.6. Scope and Delimitation of the Study

The study targets the foreign exchange allocation control performance of private commercial banks in Ethiopia and its effect on the overall economic growth of the country. The study mainly takes private commercial banks performance on foreign currency allocation and management system in accordance with the directive set by NBE. The study tried to cover FX allocation control directive since 2016 to date. Specially the performance of private commercial banks after the regime of the current government.

The study tried to examine all the regulation set by NBE (i.e FXD/45/2016, FXD/45/2017 and FXD/67/2020) which further indicates the addendums of the regulations on FX allocation control and management mechanisms of commercial bank. According to NBE Directives, there are three levels of the priorities. The effect of currency allocation within the priorities might vary. But data held by NBE does not classify allocation of the currency within these categories. In addition, the private commercial banks have not sorted the allocation of the currency by the priorities. This in turn will limit the study to clearly show the effect of the FX allocation for those prioritized items and non-prioritized items. It would also limit the study from showing the effect from the economic aspect of the FX allocated.

1.7. Organization of the Study

The study will organized under five chapters. The first chapter will deal with the introductory part which bears background, statement of the problem, research hypothesis, objectives, significance, and scope/limitations of the study; the second chapter will deal with review of theoretical and empirical literatures related to the study and conceptual framework of the study. The third chapter will deal with methodology of the study which is about design of the research, source of data and methods of data analysis. The fourth chapter will present the results and discussions which summarize the results/findings of the study, and interpret and/or discuss the findings. The final chapter will be about summary of conclusions and recommendations

CHAPTER TWO: REVIEW OF RELATED LITERATURE

INTRODUCTION

In the modern economic times the foreign exchange market is commonly exercised among countries worldwide. Hundreds of currency exchanges are being traded in to USD, GBP, Yen, Euro and other currencies all round the world. One way or another FOREX have direct role on the development of country economy-(Asim & et al 2013). It has a special effect on the economy by opening a window for trading across countries worldwide. Hence, this literature part of the paper will discuss thoroughly on the concept of foreign exchange control and its management. The effect of the controlling mechanism by the legislative body on the current foreign exchange market will be shown. Following the historic review of the foreign exchange market, other countries experience on the foreign exchange control are reviewed. The overall conceptual framework of the foreign exchange market and its management practice will also be discussed henceforth.

2.1. Theoretical Review

2.1.1. Concept of Foreign Exchange

Money market plays dominant role in country's economy. Money market also provide an important mechanism in an economy for transferring short – term funds from lenders to borrowers-(frbsf, 2021). Among the traded money market are foreign exchange market. The concept of foreign exchange is the exchange of currencies of trading countries. The foreign exchange market is the market in which foreign currency – such as Euro, USD and GBP – is traded in to domestic currency. Foreign exchange markets facilitate the trade of one foreign currency for another. For example in our country mostly the three currencies (USD, EURO and GBP) are exchanged on daily basis.

Foreign exchange, or as financial institutions referred it as FOREX, is the conversion of one country's currency in to another. The value of the trading countries currency is valued according to the laws of supply and demand. A country's currency value may also be set by the country's government-(Nick, 2022). Globally foreign exchange is handled between financial institutions such as banks and all transactions fall under the auspice of Banks for international Settlement. Yet, in most countries the foreign exchange control is implemented since it is one of the determinant of economic development of a country. In our country Ethiopia, all financial institutions are governed by the legislative body National Bank of Ethiopia. Accordingly, NBE has set foreign exchange control and management directive to be followed by each business entities, individuals as well as the financial institutions operating in the country.

2.1.2. What is Foreign Exchange Control and Its Story

When a country economy grows in size, the money supply must grow with it so that prices remain stable. This indicate that the money market have huge impact on country's economic development. In today's world economy different mechanisms had been adopted by governments worldwide to control money market, among the money market control adoption are the foreign exchange control. Foreign exchange controls are government-imposed controls and restrictions on private transactions conducted in foreign currency. The government's major aim of exchange control is to manage or prevent an adverse balance of payments position on national accounts. It involves ordering all or part of foreign exchange received by a country into a common pool controlled by authorities, typically the central bank-(CFI, 2022). To further elaborate the meaning of FOREX control, Wikipedia the free encyclopedia states that foreign exchange controls allow countries to better manage their economies by controlling the inflow and outflow of currency, which may otherwise create exchange rate volatility. Countries with weak and/or developing economies generally use foreign exchange controls to limit speculation against their currencies. They may also introduce capital controls, which limit foreign investment in the country.

According to Dheeraj (2023) most exchange control systems serve as a primary means of preventing or redressing an unfavorable balance of payments. Countries use capital restrictions to try to control the exchange rates of their native currencies on global markets. The limitations may restrict residents' ability to purchase foreign currencies and nonresidents' ability to buy or sell local money. The link between capital and exchange control and trade is the key to the smooth functioning of the international economic and financial system. They represent a noticeable barrier to trade. However, their impact on international trade depends upon the controls' structure, interactions, and effectiveness concerning other economic distortions. Controlling exchange is a tax on foreign currency necessary to purchase goods and services. These controls raise the domestic price of imports. And the price rise hurts the trade. It also influences trade through a variety of channels. These include the cost of transactions, exchange rates, foreign exchange risk hedging, and financing trade.

The principal purpose of most systems of exchange control is to prevent or redress an adverse balance of payments by limiting foreign-exchange purchases to an amount, not in the surplus of foreign-exchange receipts. These controls consent to countries a better degree of economic constancy by limiting the amount of exchange rate instability due to currency inflows/outflows-(Asrat, 2021). He further state that, the government regulate the payments dealings in foreign exchange and import-export of currencies through foreign exchange control. In the exchange control state regulation exchange the free play of economic forces from the foreign exchange market. The Government regulates the Foreign Exchange dealings by Consideration of national needs. It is the monopoly of the government in the purchase and sale of foreign currencies in order to restore the balance of payments equilibrium and disregard the market forces in the decision of monetary authority. Unless otherwise, prices will decline because the quantity of goods and services will increase faster than the money supply, resulting in deflation. When the money supply increases faster than the economy, then inflation results. Hence, because goods and services have an intrinsic value and because their quantity is limited by their profitability to the suppliers, the nominal price of the goods and services is primarily determined by the quantity of money in the economy.

The exchange control influences international trade and investment as well as the payments mechanism. It applies to all types of international transactions and the government restricts the sale and purchase of all currencies. It is adopted by and is especially suited to those nations which seek to achieve economic goals by manipulating the market behavior. Exchange control maybe complete or partial. Exchange control is complete when the government has full control over the exchange market. In fact, under complete exchange control, there exists no exchange market and disequilibrium in the balance of payments is impossibility. Exchange control is partial when the government partially controls the exchange market. The exchange control applies only to certain types of international transactions and the government restricts the sale and purchase of some selected currencies-(Cole, 2005-cited in Asrat, 2021).

Each international transaction requiring payment in foreign currencies is sanctioned by the government and all foreign exchange receipts from international transactions are surrendered to the government. Exchange control is mainly intended to secure stability of fixed exchange rate and to ensure balance of payments equilibrium. It is not an appropriate measure for the free-market economies. For this reason, the system of exchange control is commonly used in the less developed countries and the communist countries. In the foreign exchange market the system of exchange control is characterized by monopoly of government's, which led governments to exercise full control over the foreign exchange market.

2.1.2.1. Understanding Foreign Exchange Control

The foreign exchange pool is prorated to cater for "essential" or priority payments abroad. It involves controlling the trading of foreign currency and transfers across national borders. The government will determine how foreign exchange earned by individuals and businesses is spent. It will be mandatory for all earned foreign exchange to be sold at the central bank at a predetermined rate. Limits on foreign currency amount that individuals and businesses can purchase from the central bank will also be put in place. Exchange control is also used to restrict non-essential imports, encourage the importation of priority goods, control the outflow of capital, and manage the country's exchange rate. Generally, countries use foreign exchange control to manage the value of the local currency.

It's not every nation that can legitimately introduce exchange control measures. According to the articles of agreement by the International Monetary Fund (IMF), only countries with transitional economies can apply exchange controls. Several western nations employed exchange control measures soon after World War II but gradually phased them out before the 1980s as their economies strengthened overtime. The phasing out of exchange controls was also necessitated by trends towards globalization, free trade, and economic liberalization in the 1990s, which does not co-exist with the application of exchange controls. Presently, exchange controls are mostly utilized by developing countries with weak economies, low exports, are import-dependent, and with low foreign currency reserves-(CFI, 2022).

2.1.2.2. Exchange Control in an Historical Perspective

In a long-term historical perspective, exchange controls do not appear to be a natural or permanent feature of western economies-(CCEET, 1993). The rudimentary state of communications technology did not represent an absolute physical obstacle to quick and sizable capital movements. In earlier times, it was matter of days but not of months for major international capital markets to adjust—a delay short enough to undermine the autonomy of monetary policy in a scenario of fixed exchange rates. According to (www.investopedia.com) many western European countries implemented exchange controls in the years immediately following World War II. The measures were gradually phased out, however, as the post-war economies on the continent steadily strengthened; the United Kingdom, for example, removed the last of its restrictions in October 1979. Countries with weak and/or developing economies generally use foreign exchange controls to limit speculation against their currencies. They often simultaneously introduce capital controls, which limit the amount of foreign investment in the country.

Since World War II, all OECD countries have resorted to exchange controls at one time or another. Only a few countries did not build up a permanent exchange control regime in the past-(CCEET, 1993). In France, exchange controls started after the First World War It then reappeared between 1939 and 1967. After a very short interruption, Exchange control was restored in 1968, relaxed in 1984, and finally abolished in 1989. Extensive and permanent exchange control regimes originated in the exceptional economic circumstances of World War II. While Australia, Canada, Finland, New Zealand, Sweden and the United Kingdom established the hard core of their exchange control regimes in preparation for , or during, the war, in a reconstruction period-(CCEET, 1993). Other countries that formerly had exchange controls in the modern period include: Argentina - between 2011 and 2015, and from 2020, Egypt - until 1995, Finland - until 1990, Israel - until 1994, Taiwan - until 1987, United Kingdom - until 1979. The justification and motivation for the imposition of foreign exchange controls vary from country to country and their respective economic situations-(CFI, 2022). Among the major motivation that driven countries to impose FOREX controls are:

- Capital Fight at unprecedented levels, mainly due to speculative pressure on the local currency, fear, and extremely low confidence levels,
- A marked decline in exports resulting in Balance of Payments (BOP) deficit
- Adverse shifts in terms of trade
- War/Conflict budgeting and
- Economic development and reconstruction.

The prevailing view was also that controls were needed to ensure the necessary protection against adverse external shocks and preserve the independence of national policies. Monetary policy in particular was used in most countries to serve two objectives simultaneously: Full employment and a stable international monetary order within the framework of the Bretton Woods system of fixed exchange rates. Law real interest rates were used to serve the former purpose while capital controls were designed to ease possible resulting pressures on the exchange rate and to preserve official reserves-(CCEET, 1993).

Despite the collapse of the Bretton Woods system in the early 1970s controls were maintained in a number of countries until well into the 1980s. The two oil shocks in the 1970s and the resulting monetary disorder were not propitious to a raid removal of controls. Countries like Australia, New Zealand and Japan moved to a managed float but, nevertheless maintained some form of exchange rate commitment. Many European currencies began to be linked each other through the "snake" from 1973 to 1979 and then through the European Monetary System (EMS). From the mid-1970s to the early 1980s, however, many countries reduced the level of ambition of their exchange control regime to what was considered as strictly necessary to the autonomy of monetary policy. It is only in the course of the 1980s that countries still maintaining capital controls began dismantling them as supply-side reform gained strength and it was recognized that controls were less and less effective for monetary autonomy-(CCEET, 1993).

In our country Ethiopia, had a foreign exchange regime that was designed to serve the needs of a very small open economy and the simple managed foreign exchange regime stayed very static and unaltered for many years. According to NBE's foreign exchange directive manual, to effect control on the allocation and utilization of the foreign exchange resource of the country, the then government issued a foreign exchange control regulation in 1977, which remained in force up to 1991. After the demise of this government and the advent of the EPRDF government, which by adopting a non-regulated economic system followed a market oriented economic management, the foreign exchange regime, over the past fourteen years, has been liberalized in gradual steps in line with the successive economic and external sector reform measures. As a result, numerous foreign exchange transaction liberalization steps have been undertaken in the foreign exchange regime of the country, albeit on a piecemeal basis, which have necessitated the need to collate and compile these numerous amendments and produce consolidated foreign exchange transaction directives. More importantly, as significant parts of the micro management and operations function of foreign exchange transactions have been transferred from National Bank of Ethiopia to private commercial banks via directive No. FXD/07/1998 issued on August 31, 1998, it becomes necessary and essential to put together all the amendments and newly issued ones in one document for ease of reference, use and knowledge of the rules of the foreign exchange regime of the country.

To this end, all foreign exchange transactions liberalization made so far and the several amendments made to the foreign exchange control regulation issued in 1977, which is not yet rescinded, have been collated and assembled to produce a consolidated set of foreign exchange transaction directives. The consolidated directives have six parts and are organized as follows: Part I contains the foreign exchange control regulation issued in 1977 where significant provisions of the regulation, especially those related to capital account control, are still intact and in force. Part II indicates amendments made to the exchange control regulation. Part III covers the directives, which transferred a major part of the micro foreign exchange functions from National Bank of Ethiopia to commercial banks. Part IV shows the subsequent amendments made to directives No. FXD/07/1998 that shifted a considerable aspect of the micro management of foreign exchange to commercial banks. Part V provides directives issued on various foreign exchange operations and transaction aspects that are carried out by commercial banks. The last part, part VI, contains amendments of the various foreign exchange functions and transactions directives.

At last, these consolidated directives are believed to give detailed information on the foreign exchange transaction rules and procedures of the country, and provide a better understanding of what the country's exchange regime is like. The directives are also expected to serve better the commercial banks, the business community, importers, exporters, foreign exchange sellers and buyers, economic agents and individuals who hold foreign currency accounts in domestic banks, those economic agents and individuals who require foreign exchange for various current international payments or transactions, etc. by making it possible to refer to one consolidated set of directives instead of having to go through the several fragmented pieces of regulatory foreign exchange legislations made over the past fourteen years.

The current active directive which is now used by private commercial banks for transparency in foreign currency allocation and foreign exchange management Directive No. FXD/77/2021. The directive puts three conditions to be practiced while allocating FCY by commercial banks. This conditions depends on the prioritized import items by the government classified as first priority, second priority and third priority.

2.1.3. Objective of Foreign Exchange Control and Management

Controls were often used for influencing long-term development in the exchange rate and the balance of payments, as suggested by the fact that foreign exchange outflows were restricted by a larger number of countries, and on a more permanent basis, than inflows were. Controls were also used for eliminating excessive volatility in the interest rates and exchange rates as short-term operations have been subject to control more frequently and for longer periods than long-term operations. Reasons for controls were, however, quite varied overtime and across countries, and several factors could be present simultaneously in a country.

2.1.3.1. Weak Currency

The most widespread justification for capital controls was to counter market pressures for a depreciation of the exchange rate without the need of a rise in domestic interest rates, which would be damaging to economic growth. FOREX controls, even when not binding, were permanently maintained by precaution in potentially weak-currency countries. Controls, of course, were especially extensive in countries facing persistently large fiscal deficits, chronically high inflation and recurrent capital flight. The government resorts to exchange control regulations to bring the exchange rate to the desired level. The countries can sell their currency from the separate account maintained for the same purpose, such as the exchange equalization fund, in the open market to reduce the currency rate. Thus, by increasing or decreasing supply, governments can overvalue or undervalue their currency depending on the situation-(Dheeraj, 2023).

2.1.3.2. Capital Shortage

Control on foreign exchange outflows were also used in catching-up OECD countries in an early stage of development where typically domestic saving was scarce and foreign currency reserve were often needed to finance the BOP deficit. Governments may observe increased trends of capital flight as residents and non-residents start making amplified foreign currency transfers out of the country. It can be due to changes in economic and political policies in the country, such as high taxes, low interest rates, increased political risk, pandemics, and so on. Hence, governments may resort to an exchange control regime where restrictions on outside payments are introduced to mitigate capital flight-(CFI, 2022).

In a fully integrated financial world, capital would flow from mature countries to catching-up countries where investment offer more attractive returns. In this context, the question of capital shortage would be irrelevant. Furthermore, capital controls would be counter-productive here; even if controls could really prevent outward investment attracted by higher returns and more diversified assets abroad, they would weaken, at the same time, incentives of residents to save and encourage consumption, as these controls may also contribute to keeping domestic rates of return artificially below international levels, they may reduce capital inflows as well-(CCEET, 1993).

According to Dheeraj, (2023) governments worldwide impose exchange control regulations to prevent capital from flowing out of the country and may limit exports. These regulations can also help the government earn revenue through the difference in buying and selling rates, stabilize the exchange rate, and even pay off foreign liabilities. In addition, control measures aim to promote exchange stability by reducing exchange rates and volatility caused by currency transfers across borders. Applying foreign exchange regulations can frequently obstruct international investors who want to transfer their money to other nations. In an ideal scenario, these measures would be helpful to stop the capital flight from a nation with a weaker currency. However, a country's exchange control act or other regulations make decisions on the above matters, which in turn decide the degree of impact.

2.1.3.3. Inflationary Capital Inflows

By contrast, restriction on foreign exchange inflows have been more episodic and more closely related to short-term monetary policy. Governments may defend their currency's value at a certain desired level through participating in the foreign exchange market. The control of foreign exchange trading is the government's way to manage the exchange rate at the desired level, which can be at an overvalued or undervalued rate. The government can create a fund to defend currency volatility to stay in the desired range or get it fixed at a certain rate to meet its objectives. An example is an import-dependent country that may choose to maintain an overvalued exchange rate to make imports cheaper and ensure price stability-(CFI, 2022). The main objective here is to prevent these capital inflows, too large to be fully sterilized, from spurring already strong inflationary pressure.

2.1.3.4. Protection of Domestic Industries

Curbs on the exchange can induce domestic industries to produce and export more, and governments can thus protect domestic trade from international competitions. The government may resort to exchange control to protect the domestic industry from competition by foreign players that may be more efficient in terms of cost and production. It is usually done by encouraging exports from the local industry, import substitution, and restricting imports from foreign companies through import quotas and tariff duties-(Dheeraj, 2023).

2.1.3.5. Restore the Balance of Payments Equilibrium

Negative balances of payments can pull down the economic growth of a nation. Depending on the circumstances, countries may restrict or remove import restrictions. Specific exchange control authority may also devalue its currencies to increase exports and bring about a steady BOP by the exchange control act or other regulations-(Dheeraj, 2023).

According to CFI, (2022) The main objective of introducing exchange control regulations is to correct the balance of payments equilibrium. The BOP needs realignment when it is sliding to the deficit side due to greater imports than exports. Hence, controls are put in place to manage the dwindling foreign exchange reserves by limiting imports to essentials items and encouraging exports through currency devaluation.

2.1.4. Techniques of Restriction

2.1.4.1. Capital Account Operations

Direct quantitative limits on capital transactions were the most widespread form of controls across countries. Weaker forms of controls were, however, used in some cases. Countries used to implement dual foreign exchange market in which current-account transactions and capital transactions (possibly including access of residents to foreign exchange for travel purposes) were undertaken through separate channels. These two-tier exchange systems did not conflict with the provisions of Article VIII of IMF Agreement so long as a uniform exchange rate was used for current-account transactions, the definition of which could for the occasion not include travel abroad-(CCEET, 1993). It further states that, the main advantage attributed to a dual foreign exchange market is that it insulates current-account transactions from the influence of the exchange rate which applies to financial transactions, without by so doing prohibiting international capital movements. In practice, this system entailed heavy administrative management and proved of limited effectiveness in cases of crisis unless reinforced by supplementary restrictive measures.

2.1.4.2. Currency Pegging

The pegged exchange rate system incorporates aspects of floating and fixed exchange rate systems. Smaller economies that are particularly susceptible to currency fluctuations will "peg" their currency to a single major currency or a basket of currencies. These currencies are chosen based on which country the smaller economy experiences a lot of trade activity with or on which currency the nation's debt is denominated in. For example, if a small nation that does a lot of trade with the USA decides to peg its currency to the US dollar, its currency will fluctuate in value in roughly the same manner as the USD. The practice eliminates high-magnitude fluctuations and makes the smaller economy's currency a safer investment. Larger economies are less hesitant to set up trade deals with such currencies since their value will likely not fluctuate beyond reasonable levels. When pegged exchange rate agreements are set up, an initial target exchange rate is agreed upon by the participating countries. A fluctuation range is also set in place to outline acceptable deviations from the target exchange rate. Pegged exchange rate agreements usually have to be reviewed several times over their lifetimes in order to adapt the target rate and fluctuations to the changing economic climate. Such systems have proven to reduce the volatility of currencies used in developing economies and have placed pressure on governments to be more disciplined with monetary policy choices. However, this does open up the possibility of investor speculation, which may have an effect on the value of the currency. Pegged rate systems may be abandoned altogether once the weaker currency gains momentum and sees its actual market value jump well ahead of its pegged value-(CFI, 2022).

According to Economic Times May 19, 2023 publication the value of currency undergoes fluctuations depending on the internal and external affairs of a country. The rise and fall in the rate determine the supply and demand for the Exports and Imports of a country, adding values to its revenue. A fixed rate is assigned to the domestic currency in exchange with a foreign one in order to bring better stability and simplify trading between countries. The process is called

Pegging and this is a significant aspect in forex trading. Pegging is the process of setting a fixed rate of exchange for a currency with that of another. Domestic Currency is a medium of transaction within a country. This is also called as the Primary Currency. Foreign Currency is the one used outside a country for monetary exchange. Since the value of either are subject to changes frequently, the central banks or the Government makes efforts to fix a standard rate of exchange between the two countries involved. When there is a drop or rise beyond the assigned value of a peg, the Central banks trade or purchase it in the market.

With the intention of bringing and maintaining stability, the fixed rate helps the value of domestic currency keep up its pace with the variability of the foreign currency in the market. Some countries have their currencies pegged to the US Dollars. It is the most pegged by many different countries because of its market value and Import-Export relationships across the globe. Some countries get their currencies pegged to gold for its characteristic to change according to the demands and supply in trade. The concept of Stable coins in the crypto currency world is based on pegging.

2.1.4.3. Legal Framework

Except very few developed countries which never put in place a permanent legal framework for their limited and episodic use of exchange controls, the law in other countries provided that all transactions were restricted unless otherwise specified. This provision was largely of a precautionary nature, so as to allow governments to take backward in case of necessity. It is only at a later stage, when a country committed itself to move towards a full liberalization of the core exchange controls, that the opposite approach, declaring operations a priori all free, was adopted- (CCEET, 1993). CCEET further states that, exchange control instruments have generally been applied on an *erga omnes* basis as concerns capital inflows which are primarily responsive to interest rate differentials and exchange-rate expectations such as short-term portfolio investment and financial credits. Otherwise non-residents could have easily circumvented controls through triangular investment from countries which were not affected by the restrictions.

Foreign investment legislation has two general purposes: to control and to encourage/promote foreign investment within its territory. In countries actively seeking foreign investment because of a shortage of local capital and technology, the legislative framework tends to emphasize the promotion aspect. In countries which are wary of private participation, the emphasis is more on control than encouragement. Regulations may limit the level of foreign ownership of any domestic company or in the project company being granted a specific concession. Such constraints will concern a foreign investor if it prevents it from having management control of the project company. The investor may be able to limit this risk by mechanisms such as weighted voting rights or rights of veto on key areas that can be built into the constitution and/or shareholder agreement-(World Bank, 2020).

2.1.4.4. Enforcement Procedure

In the vast majority of countries, the banks played a key role in the implementation of controls. To ensure foreign exchange is allocated in a transparent and sound manner to priority and other economic sectors without opening a room for rent seeking behaviors and malpractice. Banks are required to have transparent and sound FOREX allocation and foreign exchange management guideline or procedure manual which shows the accountability of each employees of a bank involved in the foreign exchange transactions-(NBE, 2021). Transactions had to be carried out through "authorized" private commercial banks and certain other foreign exchange dealers, which were delegated authority to grant permission for properly documented operations in certain categories or up to specified amounts. Extensive reporting requirements, sometimes on a daily basis were imposed on banks in some countries, which still is operable in our country Ethiopia.

The credibility of controls required the application of extensive sanction in case of non-compliance with regulations, with certain violations being even regarded as criminal offences. First the license accorded to authorize banks and foreign exchange dealers could be withdrawn. This threat proved in many instances to be effective because licensed banks were concerned to preserve their privilege to charge generally substantial commissions on foreign exchange operations undertaken on the account of their clients. The risk of losing clients in applying exchange controls too scrupulously was on the other hand, limited at a time when the banking sector was not yet subject to competition as intense as it is today. Strong penalties could also be inflicted on enterprises and person guilty of evading controls. They ranged from fines equivalent to several times the amount of fraudulent transfers to one or more years of jail. In some countries, the, the vehicules of defrauders could also be confiscated wen crossing the frontier. Such severity may appear, by current standards, somewhat excessive. In practice, it was intended primarily to exert a dissuasive effect and most extreme sanctions were rarely applied-(CCEET, 1993).

2.1.4.5. Full-Fledged System of Exchange Control

The government controls the exchange rate and all foreign exchange transactions in this system. The control authority receives all export and other transaction receipts. In this sense, the government is the only foreign exchange dealer-(Dheerja, 2023). Under full-fledged control system, the Government does not only Peg the Rate of Exchange but have complete control over the entire foreign exchange transactions. All receipts from exports and other transactions are surrendered to the control authority i.e., National Bank of Ethiopia surrendering 70% of FCY inflow from banks. The available supply of foreign exchange is then allocated to different buyers of foreign exchanges on the basis of certain pre-determined criteria. In this way the Government is the sole dealer in foreign exchange-(Saqib, 2022).

A full-fledged system of exchange controls establishes a complete government control over the foreign exchange market of the country. Foreign exchange earned from exports and other sources must be surrendered to the government authorities. The available supply of foreign exchange is then allocated among the various buyers (importers) according to the criterion of national needs and established priorities. From a purely BOP standpoint, the sole purpose of exchange controls, is to ration out the available supply of foreign exchange in accordance with national interests. There are also a variety of milder forms of exchange control which merely limit certain sources of demand for foreign exchange; thereby they try to minimize their pressure on the BOP deficit. For example, a country may restrict foreign tourism or foreign study by the nationals of the country, in order to save foreign exchange. Similarly, domestic residents may restrict some of the capital transfers abroad, again to conserve scarce foreign exchange. Partial exchange controls such as these may be scrapped if a more basic improvement in the foreign exchange earnings has occurred.

2.1.4.6. Payment Arrangements

In a payments arrangement the usual procedure of making foreign payments through the exchange market is left intact. But each country agrees to establish a method of control whereby its citizens are forced to purchase goods and services from the other country in amounts equal to the latter's purchase from the first country. Another type of payments agreement is one designed to collect past debts-(Saqib, 2022). To overcome the difficulties of delay involved in settling international payments and for the centralization of payments observed in clearing agreements, the device is defined as payment agreements. In a payments arrangement the usual procedure of making foreign payments through the exchange market is left intact. But each country agrees to establish a method of control whereby its citizens are forced to purchase goods and services from the other country in amounts equal to the latter's purchase from the first country. Another type of payments agreement is one designed to collect past debts. The system of payment agreement solves two major problems experienced under the system of clearing agreement centralization of payments, and the problem of waiting for the exporters. Under this scheme, a creditor is paid as soon as information is received by the central bank of the debtor country from the creditor country's central bank that its debtor has discharged his obligation and vice versa. Payment agreements have the advantage that direct relation between the exporters and importers is maintained (Kent, 2010-cited in Asrat, 2021).

The advantage of payment agreement is that the direct relation between the exporters and importers is maintained and there is no need for centralization of payments. The payments between the concerned parties are made through special non-resident accounts opened for that very purpose. However, payment agreements suffer from two defects: The agreements could only be debited or credited for licensed payments, and the balances in the accounts could only be used for payment from one partner to another-(Asrat, 2021).

2.1.4.7. Clearing Agreement

It is a revolutionary innovation to the international and commercial systems. Clearing agreement refers to a system under which agreement is made between two countries for settling their international trade accounts through their respective central banks. In the words, Clearing Agreement is an agreement between the governments of the two countries by which each undertakes to make payments to its exporters which it receives from its own importers (Kent, 2010-cited in Asrat, 2021). A clearing agreement consists of an understanding by two or more countries to buy and sell goods and services to each other, at mutually agreed exchange rates against payments made by buyers entirely in their own currency. The balance of outstanding claims are settled as between the central banks at the end of stipulated periods either by transfers of gold or of an acceptable third currency, or the balance might be allowed to accumulate for another period, pending an arrangement whereby the creditor country works of the balance by extra purchases from the other country-(Saqib, 2022).

Under the system, exchange clearing agreements are made between two nations for settling their accounts through their central banks. It consists of an understanding by two or more countries to buy and sell goods and services to each other, at mutually agreed exchange rates against payments made by buyers entirely in their own currency. The importers instead of making payment for the imported goods in foreign currency pay in home currency to their central bank. Similarly, the exporters, instead of receiving payment for goods exported in foreign currency receive it through the central bank in the home currency-(Asrat, 2021).

Thus, the individual importers and exporters need not clear their accounts in foreign currencies, but in home currencies through their respective central banks and the transfer of currencies from one country to another is avoided. The balance of outstanding claims are settled as between the central banks at the end of stipulated periods either by transfers of gold or of an acceptable third currency, or the balance might be allowed to accumulate for another period, pending an arrangement whereby the creditor country works of the balance by extra purchases from the other country. Clearing between individual exporters and importers is not allowed, but done country-wise at an interval of time. Under the system, the importers pay in domestic currency to central bank and exporters get payment through the central bank in the home currency. If the exports and imports of the two countries balance with each other, no further difficulty arises. But, if the exports and imports of the two countries are not equal to each other, the net balance in the clearing account is paid off in terms of gold. In this way, stability of exchange rate is maintained through clearing agreement.

2.1.5. Conditions Necessitating Foreign Exchange Control and its Effect

Theoretically, the impact of exchange and capital controls on trade is somewhat ambiguous. Exchange and capital controls affect trade through a multitude of (interrelated) channels, including the domestic price of imports, transactions costs, and the volatility of exchange rate, intertemporal trade, and portfolio diversification. The overall effect of exchange and capital controls on trade through these channels critically depends on the structure and effectiveness of exchange and capital controls and their interaction with other distortion in the economy. The basic economics of exchange controls is similar to that of quantitative restrictions on imports of various goods and services. By taxing foreign money required to purchase foreign goods and services, exchange controls cut the quantity imported and/or raise the domestic relative price of imports. Exchange and capital controls often raise transaction and other trade-related costs, reducing trade. Costs and uncertainty associated with international transactions increase because exchange controls tend to stifle the development of liquid and efficient foreign exchange markets and modern payment instruments. Additionally, exchange and capital controls often encourage evasion and rentseeking, which impose additional unproductive costs on firms-(Natalia, 1998).

The exchange control device is not effective in all cases. Only in selective cases, this measure of curbing imports is effective. The exchange control is necessary and should be adopted to check the flight of capital. This is especially important when a country's currency is under speculative pressure. In such cases tariffs and quotas would not be effective. Exchange control being direct method would successfully present the flight of capital of hot money. It is effective only when the balance of payment is disturbed due to some temporary reasons such as fear of war, failure of crops or some other reasons. But if there are some other underlying reasons, exchange control device would not be fruitful. Exchange Control is necessary when the country wants to discriminate between various sources of supply. Country may allow foreign exchange liberally for imports from soft currency area and imports from hard currency areas will be subject to light import control. This practice was adopted after Second World War due to acute dollar shortage-(Saqib, 2022).

Exchange controls can be effective in some instances, but they can also come with negative consequences. Often, they lead to the emergence of black markets or parallel markets in currencies. The black markets develop due to higher demand for foreign currencies that is greater than the supply in the official market. It leads to an ongoing debate about whether exchange controls are effective or not.

2.2. Empirical Review

Financial crises have become a pervasive phenomenon throughout history-(Allen, Babus, & Carletti, 2009-cited in Alem & Gidefew, 2020). It is in this case that currency crises have always been a feature of the international monetary system, both during the Bretton Woods system of generalized fixed parities among major industrialized countries in the post-World War II period as well as after its breakdown in the early 1970s-(Glick & Hutchison, 2011, cited in Alem &

Gidefew, 2020). Dramatic incidents of currency crises include the breakdown of the Bretton Woods system in 1971-1973, the Pound Sterling crisis in 1976, the near-breakdown of the European Exchange Rate Mechanism in 1992-1993, the Latin American Tequila Crisis following Mexico's Peso devaluation in 1994-1995, the financial crisis that swept through Asia in 1997-1998 and, more recently, the global financial crisis of 2008-2009 that forced sharp depreciation in many of the world's advanced as well as developing economies-(IMF, 2009, cited in Alem & Gidefew, 2020).

Foreign Exchange control system had been implemented worldwide ever since world I and II regime to date. On December 31, 2021, new legal framework for foreign exchange were entered in to force, simplifying foreign currency transactions in Brazil and introducing important rules on how to supply information to the Central Bank about Brazilian Capital abroad and foreign capital in the country. Brazilian foreign-exchange policies brings them more in line with the standards endorsed by the Organizations for Economic Cooperations and Development (OECD). The new provision benefits both companies and individuals by reducing operational costs and risks arising from exchange rate fluctuations. The new foreign exchange market is regulate by the Brazilian Central Bank-(Jafferson, 2023). He further explained that before this control framework the responsibility of classifying the nature of foreign exchange transactions fell on banking institutions and brokerage firms. The new rule have simplified multiple reason in the country like that of the abolishment of prescribed formats for foreign exchange contracts, ancillary documents not required for signing foreign exchange agreements, partly responsible for classifying the nature of transactions, reduction in the number of transaction classification codes, extension of the period for retaining ancillary documents, Principal and interest on loan received abroad can now be paid in other currencies using international accounts, updated definition of foreign credit, on relaxation of foreign capital registration and on foreign direct investment and unification of statements.

According to Central Bank of Nigeria (CBN) official website, the country have gone through four foreign exchange control and management movement ever since 1986 to date. Before 1986, importers and exporters of non-oil commodities were required to get appropriate licenses from the Federal Ministry of Commerce before they could participate in the foreign exchange market. The authorization of foreign exchange disbursement was a shared responsibility between the Federal Ministry of Finance and the CBN. The Federal Ministry of Finance had responsibility for public sector applications, while the Bank allocated foreign exchange in respect of private sector applications. Exchange control was discarded on September 26, 1986 in order to evolve an exchange rate mechanism that would better reflect the underlining macroeconomic realities. The Second-tier Foreign Exchange Market (SFEM) came into being on September 26, 1986 when the determination of the Naira exchange rate was made to reflect market forces. The CBN and the government have actively fostered the development of institutions such as the Nigerian Export Promotion Council (NEPC) and the Nigerian Export-Import Bank (NEXIM) in the drive to earn more foreign exchange. The AFEM metamorphosed into a daily, two-way quote Inter-Bank Foreign Exchange Market (IFEM) on October 25, 1999. The IFEM is expected to broaden and deepen the foreign exchange market on daily basis and discourage speculative activities. The third tier the Retail Dutch Auction System (RDAS), Wholesale Dutch Auction System (WDAS) and Interbank Rate System Regime were used within the period of 2002 to 2015. The fourth tier which is still being implemented to date, the Bank adopted the managed floating exchange rate regime to enhance efficiency and facilitate a more liquid and transparent foreign exchange market, due to increased demand pressure in the foreign exchange market coupled with low accretion to reserves, arising from declining receipts from crude oil sales. The Central Bank of Nigeria is issued a guideline for the operationalization of the regime. The guideline removed tight currency control on the naira, leaving the market forces to determine the value of the currency. Further to the CBN FOREX control details some scholars have said plenty on the interruption of the CBN on FOREX control system in the country. Among the scholars, Taiwo (2015), suggested that it is clear that the CBN is making a lot of effort to address a rather difficult situation but their job is made more difficult and less effective due to the lack of complementing fiscal policy measures. While there is no golden bullet to tackle all the problems at once, it is important that the monetary policy efforts are complemented by robust fiscal policy measures. To starve importers of foreign exchange funds so as to encourage local production as substitutes is to attempt to use monetary policy measures to achieve a goal that is better served by fiscal policy. As the gap in exchange rates widens, and the uncertainty regarding what else may be added to the "Not Valid for Forex" list, the economy seems to be suffering from the pains of naira devaluation without deriving any of its benefits like higher tax revenue. The real issue is that there is rising inflation due to high cost of imports; cost of goods and services increase because many cost items are incurred at black market rates while foreign currency revenue will be reported at the lower interbank rate resulting in lower tax payments. The only sustainable solution is to have a coherent monetary policy framework complemented by a robust fiscal policy else it will be as unrealistic as hoping that a man standing on one leg will maintain his balance for a long time.

Addael, et al. (2014) cited in Asrat, (2021) had a look at the performance of Ghanaian banks particularly due to control on foreign exchange by the central bank. The study was conducted by using bank specific factors between the years 2005 and 2010. Qualitative and quantitative approaches were adopted while undertaking this study as well as econometric models. The study results showed that the banks under review were negatively affected by the amount foreign currency provided to prioritized sectors by the central bank. In contrast, the amount of foreign currency allocated to non-priority area has positive effect on profitability of the banks.

Kairu (2016), cited in Asrat (2021) examined the rationing of foreign exchange on performance of private commercial banks in Tanzania. The study had taken 43 banks as a sample and adopted a descriptive research construction. The study identified that there was a weak positive relationship between exchange rate control and the performance of the commercial banks. The finding also indicates that there was a higher attention was provided more profitable sectors in the country like agriculture and manufacturing. The control enabled to work closely with businesses that high demand from the public.

Cletus et al. (1997), argued that, exchange rate controls were the dominant policy pursued in Ghana, Uganda and Nigeria before reform. This policy seems to have been adopted based on the arguments that exchange control ensures the stability of the currency. While some researchers emphasize this attribute of a fixed exchange rate regime, others argue that given the structure of developing countries' economies, the optimal exchange rate policy is a fixed rather than flexible one. Some other proponents of the fixed regime make the point that flexible exchange rates are not thought to be desirable especially in the third world because they are unpredictable and susceptible to foreign and domestic currency speculation. Such unpredictable fluctuations can wreak havoc on both short- and long-range development plans.

Dr. Philippe (2001) states that Arab countries along with their associated negative effects on growth make the adoption of flexible exchange rate regimes an attractive alternative in improving competitiveness. In light of policy-makers’ continuous discretion in making choices under a pegged regime, a lot is riding on the authorities' ability to reliably maintain an exchange system that is compatible with stable markets expectations and confidence and hence with a viable overall monetary order. Moreover, under a pegged system, intervention in the foreign exchange market by the central bank would be as frequent as it is necessary to keep the exchange rate in line—monetary authorities are committed to stabilize the exchange rate. In contrast to a flexible regime, under a pegged regime, priority ought to be given to the constancy of the exchange rate (ahead of the maintenance of internal monetary stability). But what must be observed, particularly in three Mashreq economies (Jordan, Lebanon and Egypt), is a rationale calling for exchange rate smoothing as a policy that is not aimed at resisting market-determined movements in an asset price, but at mitigating potentially destabilizing effects of abrupt changes in that price. Otherwise, disadvantages of the fixed and pegged regimes in terms of selling free insurance, discouraging risk assessment and hedging, shifting burden of adjustment elsewhere and distorted asset allocation process (Asia 1997) will eventually destabilize any economy in the world.

2.2.1. Empirical Studies in Ethiopia

Ethiopia being one of the developing countries in Africa, as part of economic growth FOREX have its huge impact. Accordingly, in order to address the issues of Foreign Exchange Control and its management by financial sectors operating in the country, many studies had been conducted by academic institutions, international organizations and other individual researchers. Some mentioned that the country is in depth foreign exchange crisis and needs some policy adjustments, while others argue on foreign exchange rates only, other even have discussed the backward allocation system that is affecting the countries international trade which later have a direct effect on the overall economic growth of the country.

The research conducted by Tetra Tech International Development (TTID), (2022), following the change in the economic management system of the country in May 1991, the foreign exchange regime was liberalized gradually. The National Bank of Ethiopia (NBE) is mandated to i) formulate and implement exchange rate policy, ii) manage international reserves, iii) set limits on foreign exchange assets that banks can hold, and iv) set limits on the net foreign exchange position of banks. The NBE controls foreign exchange transactions under the Bank of Ethiopia Establishment Proclamation and associated Directives, Guidelines, and Letters (FNG 2008:

4181). It further indicates, as the foreign currency shortage worsened, the NBE introduced foreign currency allocation requirements to direct foreign currency with the ambition of i) maintaining the stability and credibility of the banking system, ii) protecting the goals of the GTP II, and iii) enhancing transparency in foreign currency allocations. The topic of access to FOREX in Ethiopia is quite complex to say the least. The study attempted to take into consideration all the different perspectives across government agencies involved and come up with recommendation suggesting that to revise the current NBE FOREX allocation directive by reducing the surrender requirement from 70 percent to 50 percent for local exporters and remittances recipients. So that local companies will have 20% more foreign currency to import.

Asrat, (2021), argued about the foreign currency exchange control focus which is on transparency of allocation of foreign currency to priority areas and its implementation through directive to private commercial banks in Ethiopia by NBE since 2016. He further states that allocation of foreign currency to the priority sectors have positive effect on performance of the banks. On the other hand, allocation of the currency to non-priority sector has negative effect on performance of the banks. Kidist (2018)-cited in Asrat, (2021) concluded that there is positive association between exchange rate and banks performance in Ethiopia. The finding shows that an increase in an exchange rate results in significant increase on the returns of the banks regardless of an increase in operating costs, on which the negative effect eliminated due to asset revaluations.

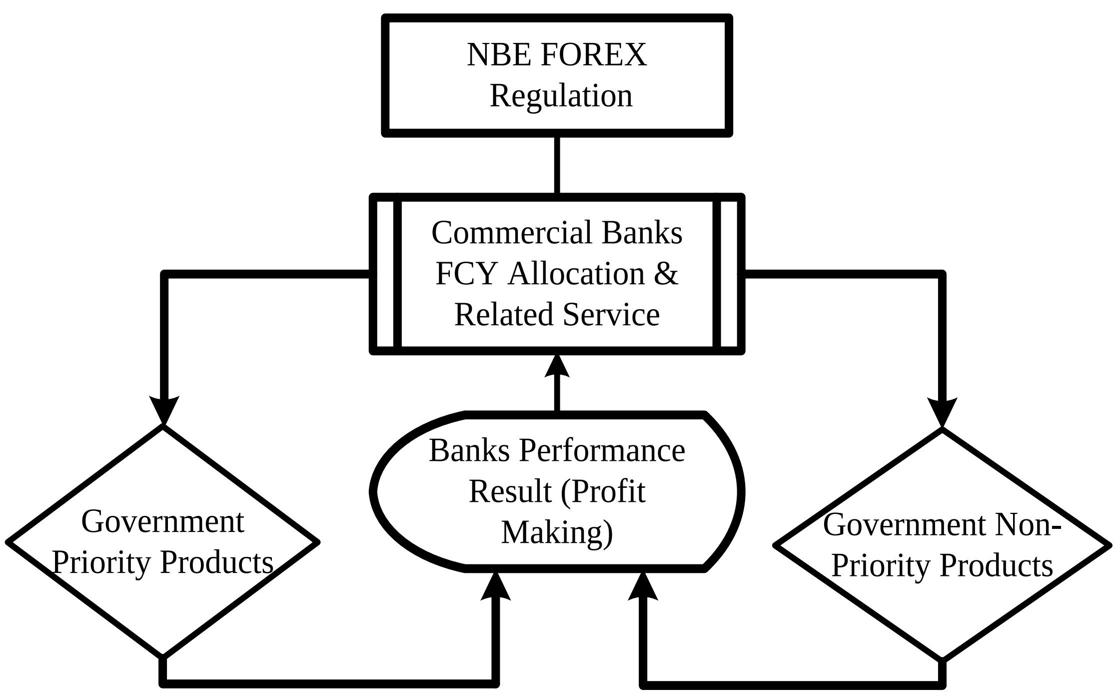
Fiseha (2019), argued and concluded that from an international perspective, a policy of currency devaluation may entail beggar-thy neighbor effects. Conventional wisdom posits that competitive devaluations (also known as currency wars), with many countries manipulating their currencies to bolster competitiveness, are likely to neutralize one another and thus may not correspond to an optimal strategy. If Ethiopia and its major trading partners simultaneously pursue devaluation, they might undercut each other's exports and indulge in a classic 'competitive' race-to-the-bottom, which leads to a situation where all countries reap no benefit.

According to Minhaj and Gedifew (2020) discussed about the causes and impacts of foreign currency crisis in Ethiopian and Finally, recommends that the coordinated efforts of anticorruption agencies along with the relevant sectoral offices are urgently needed in order to combat the excessive corruption practices, to eliminate the black market on currency, to speed up the privatization of government dominated economic sectors through encouraging private investment, and developing the strategies of liberal economic structure so as to accommodate the public interest. Such policy directions should be implemented in order to maintain the potential foreign currency reserve position of the country.

2.3. Conceptual Framework

For developing countries like Ethiopia, utilization of every resource in mobilizing and reserving enough foreign currency for the overall economic development is fundamental. As it has been mentioned above the foreign exchange control and foreign exchange rate were driven due to the vast scarcity of foreign currency in the country. The governments rule in surrendering 70% of each financial institutions have also brought great negative impact on their performance, which later be reflected on the overall economic situation of the country. The conceptual framework of this study paper will show the overall interrelationship between the government foreign exchange control and financial institutions performance on the below figure 2.1 as well as its impact on economy situation of the country.

Figure 2.1. Conceptual Framework



Source: Own Diagram, 2023

CHAPTER THREE: RESEARCH DESIGN AND METHODOLOGY

INTRODUCTION

Ethiopia has achieved sustained high growth for more than a decade. At the same time, the country has been facing several economic challenges, including falling exports, chronic foreign currency shortages, as well as a slow pace of structural transformation. In recent years, the already overvalued birr has appreciated sharply in real terms, partly driven by the appreciation of the dollar, thereby making Ethiopia's competitiveness and industrialization drive more difficult. There is robust evidence that a real devaluation stimulates exports in general and manufacturing exports in particular, improves the trade and current account balances, and spurs economic growth-(Fiseha, 2019). According to NBE's foreign exchange directive, the foreign exchange regime of the country, reflecting the economic setting, the economic management system, the economic policy of the different governments in power, the structure and level of the economic development of the country, the performance of the external trade sector and balance of payments position of the economy, etc has experienced gradual changes and openness over the past four decades.

Following this, foreign exchange market being the sensitive agenda, the government imposes foreign exchange control system to be practiced by the financial institutions operating in the country. Though there are many FCY mobilization options are available, the country economy being agrarian economy based made it suffer from earning enough foreign currency due to the un- satisfying export performance. There is scarcity of foreign exchange (expressed as a gap between demand and supply) caused mainly by poor growth of exports and unproductive imports of foreign goods. This and other reason being the force-measure, NBE have implemented the foreign exchange control that forces banks to surrender their 70% FCY earning to the government.

This in turn affects institutions performance and their rate of return. Among the highly vulnerable institutions are financial institutions who are highly affected by the foreign exchange control system of the country. This chapter deals with the description of the study area on banks FCY performance, the Methodology used to conduct the study.

3.1. Banks Foreign Currency Mobilization Strategy and Management

Banks play a key role in an economy in terms of enhancing both allocative and productive efficiency. They help to mobilize and distribute idle resources to potentially productive sectors, aiming to raise the level of economic development as a whole-(Allen & Carletti, 2012) cited in Aklilu et al. (2023). Several sources are identified by commercial bank's corporate strategy as major sources of foreign currency. Some of them are remittances, export and cash purchase (service receipt). All this being executed as per the foreign exchange control regulations set by the NBE.

3.1.1. FCY Mobilization via Remittance

Remittances are among the foreign currency sources of private commercial banks in Ethiopia. It has become a rising sources of foreign exchange and hold immense potential as drivers of economic growth and development. Remittance consists of the money transfer made from foreign countries to Ethiopia for different purposes. Often the term remittance is identified for individual's remittance transfers made through international remittance service providing agencies. This RSP's are allowed to give service in the country through local banks. Each banks in Ethiopia agreed with the RSP's and give remittance service in the country.

Remittances are also 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-(Andersson, 2012- cited in Anteneh, 2016).

Since, holding foreign currency for citizens for no reason is forbidden in the country each transferred remittances are paid to the final recipient by converting the FCY to ETB per the NBE daily prevailing exchange rate set. Accordingly, the operation is provided by banks to individuals or last recipients in the country using the NBE's remittance providing regulations. The unique part of this FCY mobilization scheme is that the NBE's regulation is set for only operation level, FCY earned via individual remittance is not included in the 70% surrendering. Which makes it highly competitive in the country and commitment free FCE mobilization strategy of commercial banks.

3.1.2. FCY Mobilization via Export Proceed

The country has given greater attention to external trade policies than any other prevailing economic policy. Accordingly, a number of incentives have been put in place-(Anteneh, 2016). explains that duties on all exports are now removed; a financial credit support system (Export Guarantee Credit Scheme) to the export sector for pre and post shipments is structured, an export trade duty incentive scheme, duty draw back scheme, voucher scheme, and bonded manufacturing warehouse scheme are made operational; and the foreign credit scheme allows foreign suppliers to extend trade credit to Ethiopian partners-(Moges, 2008-cited in Anteneh, 2016). With all the export incentives provided by the government to encourage export market in the country, due to different force-measures and political situations of the country export proceed shows declining result. According to Regulations No. 270/2012 or 270/2005 EC, export trade of raw coffee, chat, oil seeds, pulses, hides and skins bought from the market and live sheep, goats and cattle not raised or fattened by the investor is exclusively reserved for domestic investors. Foreign investors cannot be involved in export trade of these items from Ethiopia-(Anteneh, 2016).

3.1.3. FCY Mobilization Via Cash Purchase

Each banks while expanding their network via in all country side, each networking branches are required to secure FCY purchase license from NBE prior to their cash purchase service. Then the cash purchase service is provided using the prevailing conversion rate. Banks buy Euro, GBP, and USD by referring the prevailing exchange rate provided by NBE on daily basis. Among the other currency's that are allowed by the NBE to be purchased by and sold to local banks the major and majority transaction is done on the three currencies notes (EURO, GBP, and USD).

3.1.4. Foreign Direct Investment

Foreign direct investment (FDI) is an integral part of an open and effective international economic system and a major catalyst to development. Yet, the benefits of FDI do not accrue automatically and evenly across countries, sectors and local communities. National policies and the international investment architecture matter for attracting FDI to a larger number of developing countries and for reaping the full benefits of FDI for development-(OECD, 2002). This being the case, FDI in the country is also one of the foreign currency mobilization scheme. Yet FDI's investing in the country brought their own foreign currency for investment purpose which gives banks extra means of mobilizing foreign currency.

3.1.5. Foreign Exchange Control Implementation by Banks

Foreign currency being one of the major resource for banks to execute their international service transactions, each and every aspect of foreign currency mobilization schemes are transacted throughout the country as per the NBE's foreign exchange control regulation directives. Each foreign exchange service have its own Directives set by the NBE to be followed. Banks following the NBE directives in performing their FCY mobilization. Other than the directives set for mobilization Banks are regulated on the consumption of the FCY mobilized. Each banks are forced to following the foreign exchange allocation and management control directive while allocating foreign currency for import proceeds. Accordingly to Anteneh (2016), Ethiopia imports a wide range of goods: from heavy machinery and steel to chewing gum. A large number of Ethiopian businesses are engaged in import activities. Even though the growing manufacturing industries will provide substitutes for some goods, Ethiopia will very likely continue to import most of the goods it's importing now.

Each importing item requires banks to avail foreign currency allocations. And yet, the NBE's foreign exchange control regulations to surrender 70% of export proceed to the government affects banks import service. Out of the remaining 30% export earning 10% is used for the exporters while 20% is used by banks for foreign currency allocation to importing items. Except private transfer or FCY earning via remittance service and FDI, all other foreign currency mobilized by banks are surrendered to the government, (i.e. 70% of FCY earned). This being the case, the NBE's control regulation along with the deteriorating export performance of the country expose banks to perform less in their international trade service activities.

3.2. Research Design and Approach

The main objective of research is to obtain new finding and validate existing data about phenomena studied through systematic, scientific, controlled, careful and rigorous investigation-(Neelam, 2020). In order to undertake this study, descriptive and explanatory research designs is used to examine effect of foreign exchange control and its management on performance of private commercial banks in Ethiopia. The qualitative method was applied to examine the effect of foreign exchange control on performance of the banks. Further, the explanatory analysis was conducted based on panel data analysis strategy because the dataset contains cross-section of private commercial banks in Ethiopia and yearly data about foreign exchange allocation and other control variables. The control variables were components of CAMELS model, which is an international rating system used by regulatory banking authorities to rate financial institutions, that includes Capital adequacy, Asset quality, Management efficiency, Earning power, Liquidity and Sensitivity which covers how particular risk exposures can affect institutions. This study has included most inter-linked components of the CAMEL model with FCY allocation. These components include size of banks, management efficiency and earning power. The performance of the banks was represented by financial performance indicators such as Return on Asset (ROA) and Return on Equity (ROE).

3.3. Population, Sample Size and Sample Technique

The study included all private commercial banks in Ethiopia that are currently in operation. According to NBE (2023), currently there are 28 actively operating state owned and private banks in Ethiopia including the national bank of Ethiopia. Out of the total 28 banks operating in the country, 3 of them are state owned while the rest 25 are private owned banks. The three government banks are excluded from the study due to their transaction difference from those in private. Mostly government banks handle the top priority items in full. Only private banks with more than 10 years operation were selected to execute the study which is 16 in number. The rest 9 private banks are not used due to their service level of years. Data's from this selected banks were collected from the period 2016 to date, since the foreign exchange allocation control and management regulation directives were issued by NBE on the FY2016.

3.4. Type and Source of Data

Data for this research was collected using both primary and secondary sources. For the primary data semi-structured interview questionnaire was the main instrument used in collecting from the responsible organs that handle the responsibility of foreign exchange control in the commercial banks. The interview questionnaire designs were adopted from similar researches. Using the semi structured interview, detailed information about the impacts of FCY allocation on performance of the banks and the practice of FCY allocation were collected. Different organs are responsible for exchange control in the commercial banks, the main responsibility relies on managers of foreign currency allocation team or any other assigned depending on the working habit of each banks. Mostly, banks use the adhoc committee organized for the purpose of allocating FCY. While interviewing the key informants, the researcher had briefed about the objective of the study and guaranteed that their response kept secret. For the secondary data collections banks annual reports from the period FY2016 to FY2022 were used. The study mainly uses balance sheet of the banks. Since NBE has compiled data about the balance sheet items of the banks, and to get collective data at once and avoid any ambiguity the secondary data was collected from NBE.

3.5. Method of Data Analysis and Model Specification

Six years data from 2016 to 2022 fiscal year of 16 banks in the country are used. Descriptive and regression analyses methods were employed to analyze the data. The descriptive analysis includes mean, minimum, maximum and standard deviation. The regression analysis was used to show interdependence of independent variables and dependent variable based on the panel data analysis strategies. Since this study followed panel data analysis methods, the model for the study is specified as follows.

$$ROA_{it} = \beta_0 + \beta_1 FCYPr_{it} + \beta_2 size_{it} + \beta_3 NII_{it} + \beta_4 NIE_{it} + \varepsilon$$

$$ROE_{it} = \beta_0 + \beta_1 FCYPr_{it} + \beta_2 size_{it} + \beta_3 NII_{it} + \beta_4 NIE_{it} + \varepsilon$$

$$ROA_{it} = \beta_0 + \beta_1 FCYNP_{it} + \beta_2 size_{it} + \beta_3 NII_{it} + \beta_4 NIE_{it} + \varepsilon$$

$$ROE_{it} = \beta_0 + \beta_1 FCYNP_{it} + \beta_2 size_{it} + \beta_3 NII_{it} + \beta_4 NIE_{it} + \varepsilon$$

Where;

ROA_{it} is Return on Asset of Bank i at time period of t

ROE_{it} is Return on Equity of Bank i at time period of t

$FCYPr_{it}$ is percentage of foreign currency allocated by bank i at period t to priority imports; $FCYNP_{it}$ is percentage of foreign currency allocated to non-priority imports by bank i at period t;

$size_{it}$ is size bank i at period t is measured as natural logarithm of total asset of a bank i at a period t.

NII_{it} is non-interest income of bank i at period t which is measured as ratio of non-interest

income to gross revenue of a bank at period t

NIE_{it} is non-interest expense of bank i at period t which is measured as ratio of non-interest

expense to gross revenue of a bank at period t

CHAPTER FOUR: RESULT AND DISCUSSION

INTRODUCTION

This chapter deals with finding of the study and its results from structured interview as well as the data's collected from National Bank of Ethiopia. The study focuses on examining effects of foreign currency exchange control on performance of commercial bank in Ethiopia. The government's foreign currency control and management regulation focuses on the foreign currency allocation of commercial banks. Yet the allocation control is set on the priority and non-priority sectors. Up on allocation of FCY out of the available foreign currency for allocation 10% is automatically allocated for medical items which is the top priority of the government. The rest of the amount is set as 50% for other priority and 50% for non-priority. The study was conducted by using secondary data about the financial performance of the banks and allocation of exchange within the sectors. Panel data analysis method was followed as the study data include time and cross-section of the banks. This chapter presents result of data analysis and discussion on the results. The first section of the present's results of descriptive analysis and the second section presents result of regression analysis.

4.1. Descriptive Analysis

4.1.1. Demographic Characteristics of Respondents

The research is conducted on commercial bank FCY performance in relation to the governments Foreign Exchange Control and Management regulation. Hence, in order to identify the performance of the bank and assess the impact of the legislative body (NBE's) directive on their day to day performance an interview were held with senior management and other international banking officers of commercial banks. Hence, the demographic part of the questionnaire is only for the purpose of identifying the direct responsible organ in the private commercial banks since they are the one taking responsibilities on the FCY generation and utilization. Hence out of the respondents 50% of them are engaged on supervision on trade service operation, while the other 31.3% of them are officers engaged on export operation. The rest 18.8% are relation managers working with exporters with credit facility. Respondents were selected from both sexes with 50% 50% percent each. Majority of the respondents are between the ages 35-45, which shows that they have been engaged on the international trade operations for several years. The following table shows the respondents demographic status.

Table 4.1: Demographic Representation of Respondents

Demographic Information									
Sex		**Age**		**M.Status**		**Education**		**Occupation**	
Response Category	**%age**	**Response Category**	**%age**	**Response Category**	**%age**	**Response Category**	**%age**	**Response Category**	**%age**
Female	50%	25-35	18.8%	Married	100%	First Degree	50%	Export Officer	31.3%
Male	50%	35-45	81.3%			Masters	50%	R. Manager	18.8%
		Above 45	-			Above Masters	-	Trade Service Supervisor	50%

Source: Own Survey 2023

4.1.2. FX Mobilization of Banks

Every private commercial banks needs to mobilize enough FCY in order to allocate and provide international trade service to the public. Yet, out of the mentioned FCY mobilization scheme 100% of the respondents mentioned export as their main mobilization scheme. Other than that 75% of them chose NGO's as the second means, 50% of them mentioned private transfer or MTO's as a third means of mobilizing FCY. Though the banks are using all this mobilization schemes meeting their yearly target were never accomplished, 56.3% of the bank's respondent have said, they never accomplish their target amount, while the other 43.8% of them admit on meeting their yearly FCY mobilization target. According to NBE's directive each bank should allocate and let the public use the mobilized FCY for trade and other different purpose. Hence, most of the banks make a foreign currency allocation on quarterly basis, as per the respondents 68.8% of them mentioned their bank's allocate FCY on quarterly basis, while the rest 31.3% of them mentioned their bank is allocating FCY on monthly basis.

Table 4.2: FCY Mobilization Scheme and Allocation

No	FCY Mob. Scheme	% age	FX Mobilization Target Accomplishment	% age	FCY Allocation	% age
1	Export	100%	Accomplished	43.8%	Once in a Month	31.3%
2	NGO's	75%	Not Accomplished	56.3%	Quarterly Basis	68.8%
3	Private Transfer/MTO	50%				

Source: Own Computation 2023

4.1.3. FX Control Effect

The government foreign exchange control and management regulation is set for each and every related operation of foreign currency at commercial banks. The NBE's directive to collect FCY via different schemes and to make any international payment gives its direction on how to manage. Yet, out of the sixteen banks respondent the majority 56.3% of them declare that their banks FCY generation is less while the 43.8% of them respond they have good FCY earning. Though most of them mentioned that their FCY earning is less, in contrary to that, the banks income is good from the commission and other FCY related service earning, almost 81.3% agree that their banks income is good when the others 18.8% of them disagree with it. On the other hand, whether the FCY amount is small or big at banks, 50% of the bankers mentioned that the NBE's allocation control directive helps for better performance, while 31.3% of them disagree with the majority idea and the rest 18.8% of them opposes strongly. However, 81.3% of the banks agreed that the foreign currency allocation control system benefits both the bank and their customers. Yet, 18.8% of them argue that the control system affects the bank in a negatively.

Table 4.3: FX Allocation Control Effect

No	Description	Agree	Disagree	Strongly Disagree
1	Income Generation	81.3%	18.8%	
2	FCY Mobilization Increment	43.8%	56.3%	
3	Better Allocation	50%	31.3%	18.8%
4	Control Benefit	81.3%	18.8%	

Source: Own Computation 2023

4.1.4. Description of FCY Allocation

In this section, the result of descriptive analysis is presented by using descriptive statistics such as mean, standard deviation, minimum and maximum. It was mainly conducted for performance indicators, the allocation of FCY by the banks and controlled variables. Allocation of FCY is computed by using proportion of foreign currency allocated to priority and non-priority sectors. Knowing the FX control directive is to give high importance for priority sectors, the 6 years data shows that the priority allocation is way less in all years from the non-priority. By the time the allocation control directive is set in the year 2016/2017, only 23.6% were allocated for the priority while the 76.3% were allocated for the non-priority sector. Immediate in the succeeding year FY2017/2018 the priority sector increased by 25.5% while the non-priority sector shows insignificant change by only increasing 5.52% from the preceding year. For the past continuous fiscal periods the change in the priority sector allocation show a significant percentage change while the non-priority show a minimal change. Yet, the last year FY2021/2022 priority allocation shows a big change the by 48.6%, when the non-priority sector only grew by 28.9% from its preceding year.

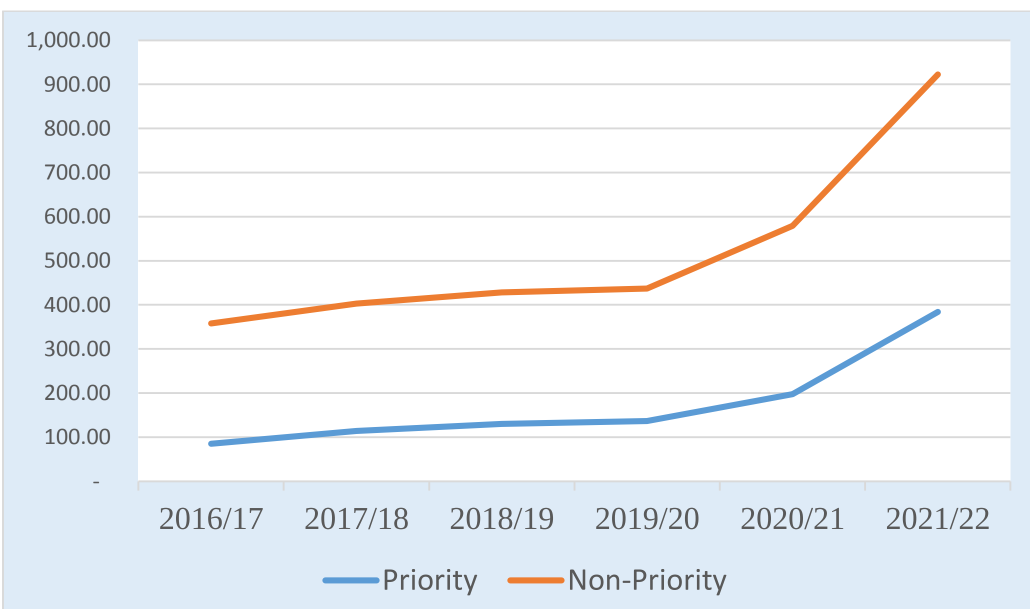
Table 4.4: Allocation of Foreign Currency

Year	Allocation	Mean	Sd	Min	Max
2016/2017 to	Priority	174.4	109.2	84.69	384.1
2021/2022	Non-Priority	346.8	100.9	273.4	537.8

Source: Own Computation 2023

According to the above table 4.4 there is a big different between the priority and the non-priority sector. Even with the FCY allocation control, the non-priority sector takes the big amount. In the year 2021/2022 there is big different between the two sectors, the non-priority sector is 28.5% bigger. The FCY allocation trend in both the priority and non-priority sector show increasing order. Each year's FCY allocation for both sector shows a rising scale. The following figure 4.1 shows the trending of FCY allocation of priority and non-priority for the past six years.

Figure 4.1. Trend of Currency Allocation



Source: Own Computation 2023

In the above figure 4.1 shown the FCY allocation trend in both the priority and non-priority shows a continuous increasing trend. Though after the implementation of the FCY allocation control directive, the allocation to priority sector show progressing increment, the non-priority sector still takes the bigger portion. In addition to this, to allocate foreign currency banks need to mobilize enough FCY as described above, hence among the major FCY mobilization schemes export takes the bigger portion. Accordingly the correlation between import and export is significant at 0.01 level. The following table 4.5. Shows the import and export correlations.

Table 4.5: Correlation between FCY Allocation and Mobilization

		Import
Export	Pearson Correlation	.978**
	Sig. (2-tailed)	.001
	N	6

Source: Own Computation 2023

4.1.5. Performance of the Banks

Association of level of allocation of the currency to the performance of private commercial banks in the country is not empirically identified. But there are opinions of the banks that restricts on allocation of the currency negatively affects performance of the banks. According to interview conducted with selected banks, the banks failed to meet demand of customers in non-priority sectors although the customers are strategic targets. Therefore, it is important to examine the effects of restrictions of currency allocation on performance of the banks. Before examining the effects, the study assessed performance of the banks and analyzed by using descriptive statistics. As indicators of performance, the study has used ROA and ROE and summarized in Table 4.6 below.

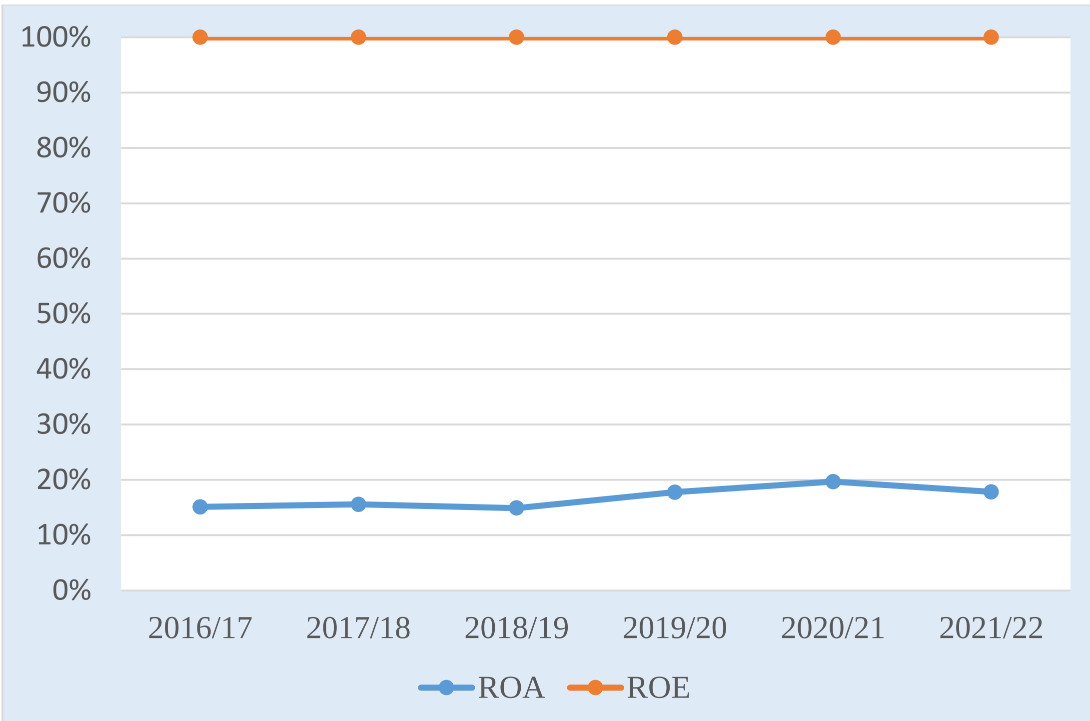
Table 4.6: Descriptive Statistics of Performance of Banks

Variable		Mean	Std. Dev.	Min	Max.
ROA	Overall	108.1	52.8	63.69	200
ROE	Overall	521.2	209.9	358.12	922.04

Source: Own Computation 2023

As shown in Table 4.6 above, mean value for ROA is 108.1 and mean value of ROE is 521.2, banks use asset of value of birr 100 to get net income of Birr 108.1. From the above result we can draw that almost all private commercial banks have different level of profitability from investment in assets. Some have high return from others. The performance trend of the banks is presented in figure 4.2, here below:

Figure 4.2.: Performance Trend of Banks

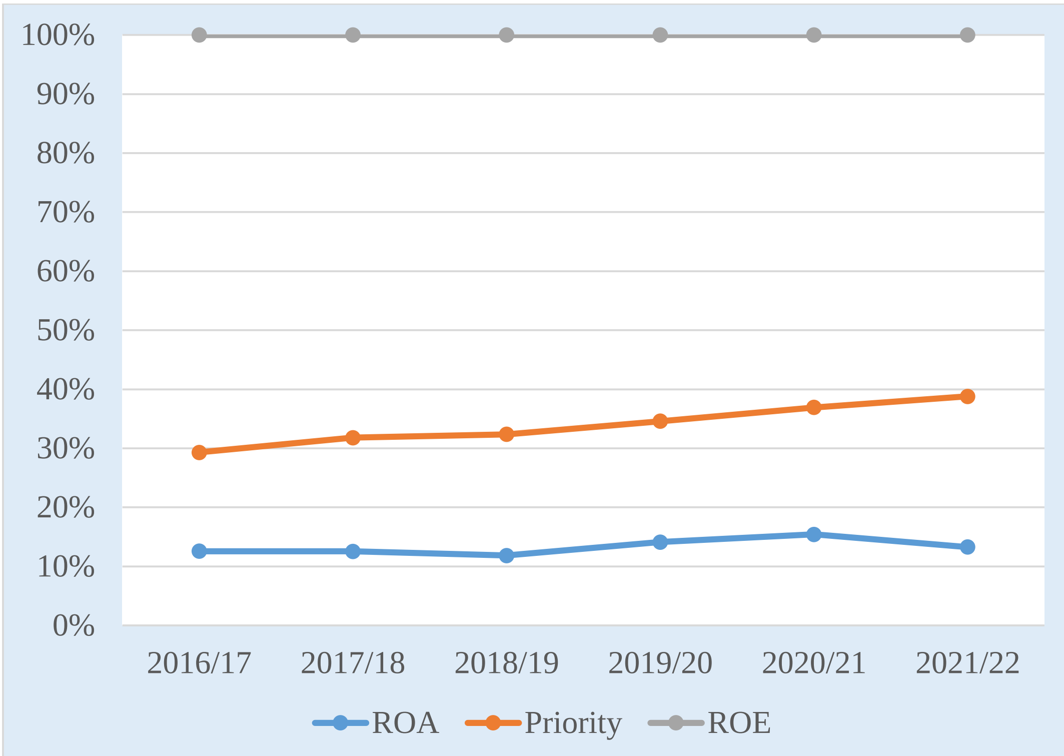


Source: Own Computation 2023

As it is shown on Figure 4.2 above, the overall ROA of the banks is closer to constant value but the currency allocation is varying from year to year. But the study suggests ROA is more sensitive to a bank than a time. In relation to variation of allocation of the currency, the banks have significant variation of profit despite highly varying level of allocation of the currency. It is not generalizable as the mean score are overall results for the banks and the time that fail to make association in each year.

In addition, the mean of ROE suggests the banks are generating net profit of 108.1 birr by using capital of 100 birr. There is high value of standard deviation for mean of ROE suggesting that return from investment in a bank varies from bank to bank. In relation to the finding about allocation of foreign currency through the descriptive statistics, ROE has small variation among the banks but allocation of the currency varies from year to year.

Figure 4.3: Performance Trend and Currency Allocation by Banks



Source: Own Computation 2023

Trend of performance and the currency allocation is presented in Figure 4.3 above. As shown in the Figure 4.3 above, currency allocation highly varies among the banks. The performance indictor, ROA has small variation among the banks and ROE is moderately varied among the banks.

4.2. Regression Analysis

In relation to different FX exchange control and management regulation of the government, this study was mainly conducted to examine the effects of foreign currency allocation on performance of private commercial banks in Ethiopia. Since the study used panel data, panel data analysis method was for the regression analysis. Therefore, the study has implemented random and fixed effect models based on the econometric procedures of panel data analysis.

For the purpose of robust regression with an intention of controlling effects of important determinants of performance and reducing omitted variables bias, this study has included control variables to the estimation model. These variables include size of the banks, management efficiency and business diversification. The size of banks is measured by using total assets of a bank.

The first procedure of the study was conducting model selection. To select appropriate model between random and fixed effect model, Hausman specification test was conducted for both ROA and ROE models. The null hypothesis of this test is random effect is appropriate model that assumes unique errors (ui) are not correlated with the repressors. The result Hausman test is presented in Table 4.6 below.

Table 4.7.: Hausman Test

Test Statistics	**ROA**	**ROE**
Chi-Square	30.	21.5
P-Value	.224	.664

Source: Own Computation 2023

As shown Table 4.7 above, Chi-square values for both ROA and ROE models are not statistically significant. Therefore, this study fails to reject the null hypothesis and it implies that random effect model is appropriate model that suggests ROA and ROE of private commercial banks in Ethiopia varies from bank to bank. Consequently, this study has adopted the random effect model.

4.3. Discussion

The study discusses on the foreign exchange control and management regulation of the government in broaden and the allocation directive specifically. Thus, to identify the effect of the FX control of legislative party, the study mainly conducted on the examination of the effect of foreign currency allocation regulation on performance of private commercial banks in Ethiopia. Based on this general aim, this study has assessed implementation status of the regulation; assessed allocation of foreign currency in priority sectors and non-priority sectors; examined effect of allocation of foreign currency to priority sectors on performance of the banks; and examined effect of allocation of the currency to non-priority sector on performance of the banks. Data collected from secondary and primary sources were analyzed by using descriptive statistics and econometric estimation.

NBE enforced directive to control foreign currency allocation to priority and non-priority sectors in 2016 with directive number of FXD/45/2016. This directive was entitled as "Transparency in Foreign Currency Allocation and Foreign Exchange Management". In the allocation of foreign currency, a bank shall give priority to the selected import items and payments. Each private commercial banks are obliged to use 10:50:50 allocation ratio of their total FCY earning. That is top priority is given to medicine and related items while the 50:50 represents priority and non-priority. The main area of the priorities are essential goods to the economy, i.e., fuel, fertilizer and other agricultural inputs, pharmaceutical product, factories‟ requests for procurement of machineries, equipment, spare parts, raw materials and accessories; and import of nutritious food for babies. The directive requires private commercial banks in Ethiopia to allocate at least 50% of foreign currency to the priority goods after allocating the 10% to medicine from the overall total FCY earning. Thus, the maximum allocation to import the non-priority goods is 50% of the currency allocated by a bank. The directive requires the banks to surrender the currency to NBE if requests to import priority goods are below 50%.

Even though the directive was implemented in 2016, implementation according to the directive were not appropriate followed by commercial banks. Until strict follow-up and the FCY surrender issue arises in 2019 banks were not strict on the priority and non-priority issue. Since mostly the priority items specially medicine is handled by very few giant companies, not all will approach all banks. Hence, the majority and perishable items including from those priority were mostly preferred by both banks and customers. Due to this and other facts, there are very high demand for foreign currency to import goods in non-priority categories. This is mainly faced by new banks since, most of the giant institutions are held with the senior banks. They were providing the currency to import of goods in non-priority categories not to lose their customers. Mostly customers move here and there to which ever offers best or whichever bank holds enough resource, due to this competition between new entrant and the senior banks become stiff. The banks were poor implementing the directive during the beginning of the implementation. Currently, implementation of the directive is seriously considered by the banks because of strict follow-up by NBE and other government legislative bodies.

On overall the 10:50:50 ration indicates that all banks are obliged to first allocate the 10% to medicine, then the rest 50% to priority 50% to non-priority, this indicates that almost 60% of the foreign currency is allocated to import priority goods however, the non-priority allocation was triple times the priority, minimum of 23% was observed in 2016 for the priority sector. It took three years to effectively implement the directive. The banks were preferring the non-priority sectors to the priority sectors while providing foreign currency. In the first year, 23.7% of the currency was allocated to priority areas and in the following year this was raised to 28.2% by showing good improvements. In the third year, 2018/19, proportion of currency allocation to priority areas became 30.8% and recently it became 41.67% of total allocation of the currency.

CHAPTER FIVE: CONCLUSION AND RECOMMENDATION

INTRODUCTION

This chapter of the study discusses the major findings in the above examination of the impact of foreign exchange control and management regulation that is being exercised among commercial bank in the country. Hence, from the finding conclusion and recommendations are drawn here below.

5.1. Summary of Major Findings

This study paper is prepared to examine the impact of foreign exchange control and management from the overall country perspective in general and private commercial banks operating in the country in particular. Hence, to make the study paper specific, it examine the effect of foreign currency allocation control and management on performance of private commercial banks in Ethiopia. The foreign currency exchange control focuses on transparency of allocation of foreign currency to priority and non-priority areas. Implementation of the FX allocation control directive began in 2016 and is still operational till date. Secondary data were used to conduct this study on allocation of FCY and included expert opinion from selected commercial banks. Panel data analysis method was followed and the study indicated that allocation of the foreign currency is rising every year and currently meet the minimum requirement of 50% of allocation of foreign currency to priority area. The result of econometric estimation indicated that allocation of foreign currency to the priority sectors shows positive effect on performance of the banks.

5.2. Conclusion

The foreign exchange control-were initially enforced in to action in the year 2016. At the beginning strict implementation of the directive were not observed among private commercial banks until 2019. The directive-were amended for several times, the current active directive which is now used by private commercial banks for transparency in foreign currency allocation and foreign exchange management is Directive No. FXD/77/2021. The directive puts three conditions to be practiced while allocating FCY by commercial banks. This conditions depends on the prioritized import items by the government classified as first priority, second priority and third priority. Consequently, implementation of the directive is improved from year to year and currently the banks are operating according the specifications in the directive. Further, willingness of the banks to comply the obligations has improved because of economic conditions in the country.

During the beginning year of implementation of the directive, compliance to responsibilities in the directive were at low level. In the first and second years of implementation, only 23.7% and 28.2% of the currency was allocated to priority areas respectively. Recently, the banks allocated to 41.67% of foreign currency to priority areas. NBE made realistic amendments and willingness of the banks is improved that contributed for improvement to allocation to the priority area. Compliance to the proportion is also contributed from shortage of the foreign currency.

Allocating the currency to the priority imports have improved performance of private commercial banks in Ethiopia. Higher demand for goods in priority imports has improved performance of customers of the banks. Allocation of the currency to these areas has reduced cost of import, hence, higher demand for the goods. In contrary to allocation to priority imports, allocation of foreign currency to non-priority sectors has resulted negative effect on performance of commercial banks. Non-priority imports have lower demand than demand for goods of priority imports. Thus, financing non-priority imports is financing less profitable businesses that results low profitable of the banks

5.3. Recommendation

- Based on the findings established by this study, it is possible to make the following recommendations:
- Currently, private commercial banks in Ethiopia are meeting the minimum requirement of allocation of foreign currency between priority and non-priority sectors. Based on importance of the priority imports for overall economy and the banks, private commercial banks in Ethiopia are suggested to increase allocation to the priority imports.
- Importers of the priority goods have potential of export and some of the companies involve in export businesses. Strategic relationship with these companies helps the banks to increase inflow of foreign currency. Therefore, it is recommended to form strategic partnership with companies that involve in import of priority goods.
- Allocation of foreign currency to priority imports and non-priority imports became important source of performance of private commercial banks in Ethiopia; allocation to the priority imports have positive role to improve performance of the banks; in contrary,

providing foreign currency to non-priority areas is becoming very hectic due to the strong prohibition from NBE and the government.

- Now a days the restriction of the government is becoming more elastic due to the current countries economic situation, therefore banks need to focus on the priority item than the non-priority sectors.

REFERENCES

Aklilu Wubet Lema, Worku Negash Motbainor, and Shumey Berhie Teshome, 2023, Banking System Policy in Ethiopia Post-1991: Domestic and Foreign Resource Mobilization, Journal of Sustainable Development in Africa, Volume 25

Alam, M., Yigzaw, G. S. (2020). Causes and Impacts of Foreign Currency Reserve Crises in Ethiopia. Üniversitepark Bülten, 9(1), 15-27.

Anteneh Girma, 2016, the Role of Commercial Bank of Ethiopia in the Mobilization of Foreign Currency to Support Fertilizer Imports, Addis Ababa University

Asim Mashkoor, Ovais Ahmed, Dr. Gobind Heerani, The relationship between Foreign Currency trading and Economic Development A case Study of Pakistan, Interdisciplinary Journal of Contemporary Research Business Vol. 5, No. 1

Asrat Abate 2021, The Effects of Foreign Exchange Control on Performance of Private commercial banks in Ethiopia, St. Mary's University

Centre for Co-Operation with the European Economics in Transition, 1993, Exchange Control Policy, Organization for Economic Co-operation and Development, France

Cletus Dordunoo, Kassey Odubogun, Gerina Ssemogerere and Louis Kaserkende, 1997, A Comparative Study of Foreign Exchange FCY Management in Ghana, Nigeria and Uganda, IDRC, African Economic Research Consortium.

Corporate Financial Institution team, 2022, Exchange control, CFI Education Inc.

Dheeraj Vaidya 2023, Exchange control, www.wallstreetmojo.com

Dr. Philippe D. Karam, 2001, Exchange Rate Policies in Arab Countries: Assessment and Recommendations, Arab Monetary Fund, Abu Dhabi.

Economics of Foreign Exchange rate, www.thismatter.com

Federal Reserve Bank of San Francisco 2001, what are the money and Foreign Exchange Markets? What Forces Influence supply and Demand in these Markets? www.frbsf.org

Federal Reserve Bank of San Francisco, June 2021, what are the Money and Foreign Exchange Markets? What Forces Influence Supply and Demand in these Markets?

Fiseha Haile 2019, The Exchange Rate Why it Matters for Structural Transformation and Growth in Ethiopia, Policy Research Working Paper, World Bank Group

International Trade Administration, 2022 Ethiopian Market Challenge

James Lloyed and Bisrat Teshome, 2018, Foreign Exchange Allocation and Access for Businesses in Ethiopia, Business Environment Reform Facility, UKaid

Jefferson Goncalves 2023, Legal Framework for Foreign Exchange Goes into Effect, www.dpc.com

Mashkoor, Asim and Ahmed, Ovais and Herani Dr. Gobin 2015, The Relationship between Foreign Currency Trading and Economics Development: A case Study of Pakistan, Munich Personal RePEc Archive

Minhaj Alam and Gedifew Sewnet Yigzaw, 2020, Causes and Impacts of Foreign Currency Reserve Crises in Ethiopia, Universtitepark Bulletin, Volume 9

Natalia T. Tamirisa, 1998, Exchange and Capital Controls As Barriers to Trade, International Monetary Fund

National Bank of Ethiopia 2016, Transparency in Foreign Currency Allocation and Foreign Exchange Management, Directives No. FXD/45/2016

National Bank of Ethiopia 2021, Transparency in Foreign Currency Allocation and Foreign Exchange Management, Directives No. FXD/77/2021

Neelam Pawar, 2020, Research Methodology (An Overview), KD Publications

Nick Lioudis, 2022 What is Foreign Exchange? Factors That Affect the Value and Rates, www.investopedia.com

Organization for Economic Co-operation and Development 2002, Foreign Direct Investment for Development, OECD Publication Service, France

Restrictions on Foreign Investors/Currency Exchange Controls, World Bank 2022

Saqib Shaikh, 2022 Foreign Exchange Control: Definition, Objectives, Types and Conditions, www.economicsdiscussion.com

Taiwo Oyedele, 2015, The current foreign exchange control regime and implications for taxation and fiscal policy, www.pwc.com/ng

Tejvan Pettinger 2017, Exchange Rate and Economic Growth, www.economicshelp.org

Tetra Tech International Development, 2022, Ethiopia: FOREX Prioritization Study, Foreign, Commonwealth and Development Office (FCDO) Africa Clean Energy Technical Assistance Facility

What is Pegging, The Economic Times English Edition May 19, 2023

Appendix: Interview Questionnaire

Interview Questionnaire: Questions for Officers in 16 banks Working on Foreign Currency Allocation and Related Services

Interview questionnaires, on Foreign Currency allocation and its management among commercial banks. The interview questions will be conducted on bank officials working on foreign currency allocation and related services.

The purpose of this research is to assess the effect of foreign exchange control on private commercial banks in Ethiopia and its management. Thus, this questionnaire is developed to collect relevant and adequate information and opinions about the sources of FCY mobilizing means that your esteemed implement, obstacles in conducting FCY mobilization and allocations, and the main challenges that is drawn from the government's foreign exchange control imposed on financial sectors in the country.

The questioner has three different blocks of questions:

I. Demographic Information
II. FCY Mobilization and its Management System in the Bank
III. Hypothesis Based Information

I would like to confirm that this research is purely for academic purpose only and passed through the necessary approval from the above mentioned institutions. All information collected through this questioner will be kept confidential.

As your response to this questionnaire is very crucial for the reliability of information as a basis for outcomes of the study including further analyses, recommendations and conclusions, I am kindly requesting and greatly appreciate your unreserved support in sharing your hand-on information taking a few minutes from your invaluable time.

Thank you in advance for your willingness to be part of this study.

I. Demographic Information

This part of the question helps to know the respondents demographic situation in terms of their age, marriage, education and occupational status by the time the interview was held.

1. Respondent Name (optional): _______________________
2. Sex: ☐ Male ☐ Female
3. Age: A) 15-25 B) 25-35 C) 35-45 D) Above 45
4. Marital Status A) Single B) Married C) Widowed D) Divorced
5. Educational Status A) Frist Degree B) Masters C) Above Maters
6. Occupation/Current Position: ____________________________

II. FCY Mobilization Scheme

7. What are the bank's FCY mobilization scheme? ___________
8. Which of the FCY mobilization schemes are most effective for the Bank performance?

Source of FCY Mobilization	Mark (✓) on your answer	Order the source according to its contribution to the banks FCY Earning (1st, 2nd . . .)
Export		
Private Transfer		
FDI		
Cash Purchase		
Other/ Specify		

9. Does your bank ever accomplish its target in its yearly FCY mobilization Strategy?
   A) Yes b) No
10. If no, what do you think is the reason? ____

    ____

    ____

11. How often does your bank allocate FCY?
    a) Once in a Month b) Twice in a month c) Quarterly Basis
12. Does your Bank comply with NBE's FCY allocation control directive?
    A) Yes B) No

13. If yes how:____
14. Do you think the directive is important for private commercial banks in Ethiopia in general and for your bank in particular? ____
15. Does the FCY allocation control directive affect your bank negatively? What do you think are the effects? ____
16. What are the positive effects of the FCY control directive on your Bank? ____

III. Hypothesis Based Information

Part One: Increase in income and control over assets

17. Does the bank FCY income improved after implementing the directive?

A) Strongly Agree B) Agree C) Disagree D) Strongly Disagree

18. Does the directive help you increase the banks FCY mobilization?

A) Strongly Agree B) Agree C) Disagree D) Strongly Disagree

19. Does the bank have better FCY allocation system now?

A) Strongly Agree B) Agree C) Disagree D) Strongly Disagree

20. Have your bank FCY mobilization and management system improved?

A) Strongly Agree B) Agree C) Disagree D) Strongly Disagree

21. Have your bank gained any benefit due to the FCY control directive?

A) Strongly Agree B) Agree C) Disagree D) Strongly Disagree