

monthly
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on the

ETHIOPIAN ECONOMY

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1. Revision of customs tariff book

Around mid-March 2021, the Ethiopian Government announced that it has finalized the overhaul of its import tariff book.¹ A major change brought about by the revision is that, whereas the existing tariff book puts duties and tariffs on *product categories*, the revised book puts tariffs on each specific product.

The revision also lowers tariffs on spare parts for locally assembled products and raw materials for manufacturers. This change has significant potential to encourage domestic production of goods that so far have been imported from abroad. The change could have positive impact on domestic production and employment. It could also reduce import-dependence of the country and thereby reducing alleviating foreign exchange shortages that have been chronic problems of the Ethiopian economy.

It is to be noted that the rate of customs duties in Ethiopia ranges from 0% to 35% with an average rate of 17 percent. In recent years, Ethiopia has reduced customs duties on a wide range of imports, including the removal of tariffs on agricultural equipment². On top of customs duties, other taxes may also be imposed on imports. These are excise duties on selected goods (e.g., tobacco), surtaxes on many imports and a 15% value added tax (VAT).³

In general, customs tariffs and other taxes levied on imports have two major objectives: to raise revenues for the public sector and/or as part of some other economic policies such as industrial policy to discourage imports and encourage domestic production. According to UNCTAD⁴, the magnitude of trade-related public revenues (e.g. from import duties, export duties, tax on profits on exports, etc.) varies considerably across low- and middle-income countries, from average 3 per cent of total public revenue to over 20 per cent. Among least-developed countries (LDCs), tariff revenues may represent a significant portion of a country's total public revenues, especially, in large part due to the fact that collecting import duties (i.e. tariffs) requires a relatively simple system (i.e. through a customs authority at the goods' entry point) as compared to other tax revenues such as value added tax, income tax or corporate tax.

¹ <https://addisfortune.news/finance-ministry-overhauls-tariff-book/>

² <https://www.privacyshield.gov/article?id=Ethiopia-Import-Tariffs>

³ <https://www.privacyshield.gov/article?id=Ethiopia-Import-Tariffs>

⁴ <https://www.un.org/esa/ffd/wp-content/uploads/2014/12/10Dec14-UNCTAD-input.pdf>





In the case of Ethiopia, the share of revenues from various duties and taxes imposed on import of goods represents a significant portion of total public revenues - well above the global average for low- and middle-income countries. For instance, for the fiscal year 2019/20, this source of public revenue accounted for 32 percent of the total public revenue for the fiscal year.⁵ This heavy reliance by the public sector on various forms of import taxes is a symptom of an overall structural weakness of the economy. More developed economies do not rely on import taxes and duties; rather, they use import duties and taxes to achieve other policies such as industrial and technology policies.

With the announcement of the tariff book revision, the Ethiopian Government has declared a clear shift in its economic policy. Instead of focusing on increasing the public revenue to be collected from these sources, the Government now sees import tariffs and duties as means of implementing other economic policies such as industrial policy and encouraging manufacturing industry. For instance the Ministry of Finance noted that the previous tariff book was “encouraging imports rather than local production....It has so many problems, such as levying a heavier duty on cotton than the end product – cloth.”⁶ Some of the industries that are expected to benefit from the new tariff structure are local assemblers, such as those who assemble vehicles, mobile phones and television sets since they will be able to take advantage of a lower duties on the spare parts they import for assembly. In addition, it is reported that raw materials for all types local manufacturing will receive customs duty reductions.

⁵ Calculated base on the Annual Report of the National Bank of Ethiopia 2019/20

⁶ <https://addisfortune.news/finance-ministry-overhauls-tariff-book/>





2. Several new commercial banks to join the Ethiopian banking industry

The National Bank of Ethiopia announced in March 2021 that four new commercial banks – namely, Amhara, Goh, Ahadu and Tsehay banks - are at the final stage of joining the rapidly growing banking industry in the country.⁷ Currently there are 17 banks that are operational in the country with an additional two (Zamzam and Hidjira), which have received the license from the Central Bank of Ethiopia (CBE) and are expected to begin service provision soon. Out of the 19 licensed banks⁸, the Commercial Bank of Ethiopia (CBE and the Development Bank of Ethiopia are state-owned enterprises, while the rest are private share companies.

According to a study by Cepheus Capital⁹, as of 2018, Ethiopia's banking sector collected Birr 730 billion in deposits (from around 33 million savers); provided Birr 733 billion of total credit; handled close to US\$ 10 billion in annual foreign exchange trading; employed 90,000 workers; delivered attractive returns to roughly 115,000 shareholders; and contributed Birr 13 billion in yearly taxes to the government (equivalent to roughly one-fifth of annual income tax receipts in recent years). Moreover, the banking sector has enjoyed high growth, high profits, and high returns—almost without interruption—for over a decade. For instance, its profits grew by about 22 percent per year for more than ten years.

The study also indicates that the traditional service offerings of Ethiopian banks are limited to providing simple deposit accounts, loans, guarantees, and Letters of Credit for importers whereas digital banking services have become more common in recent years, including ATMs, Point of Sale (POS) machines, online banking, and mobile banking. In terms of market structure, CBE is the dominant player with 62 percent market share with little change in its market share for more than a decade. Seen in relation to banks in comparable countries in Africa and Asia, the said study find that Ethiopia's private banks are: much smaller in size; very limited in their services; heavily focused on lending instead of other income sources; less burdened by bad loans; and slightly more profitable than their peers.

One outstanding feature of the banking sector in Ethiopia is the fact that banking business is not open to foreign companies. This is despite the recommendations and pressure from international financial institutions and governments of donor countries to liberalize the sector. The official justification for not

⁷ <https://www.ethiopianreporter.com/article/21581>

⁸ <https://nbebank.com/banks/>

⁹ <https://cepheuscapital.com/wp-content/uploads/2019/01/Banking-Sector-Paper.pdf>





liberalizing the sector to foreign competition has been that the domestic banking sector was still in its infancy to effectively compete with multinational banks and the lack of capacity of the government to effectively regulate and supervise foreign banks. It was announced in March 2019 that plans were underway to open the financial sector to the global market as part of the economic reform package introduced by Prime Minister Abiy Ahmed. The Government, however, has not announced any schedule or date on which it will allow entry of foreign companies into the Ethiopian banking and finance sector.

3. Revised commercial code ratified by parliament

The House of Peoples' Representatives unanimously passed the revised Commercial Code on 25th of March 2021, the first major revision since 1960¹⁰. The new Code, which is said to be geared towards spurring innovation and enterprise has been under revision for several years. With the economic reform program under the umbrella of the "Home Grown Economic Reform", however, the Ministry of Trade and Industry was given the mandate to speed-up the enactment process. Subsequently, the Ministry submitted a draft to the Council of Ministers in July 2020¹¹.

The amendment is deemed to play an important role in hastening Ethiopia's bid to join the World Trade Organization (WTO), and the changes made are expected to improve the ease of doing business and attract foreign investors.¹² According to the Ministry of Trade and Industry, in addition to speeding up accession to the WTO, the new Code will play an instrumental role in helping Ethiopia to address the sector's bottlenecks and boost global competitiveness.¹³ For instance, the new Code is expected to facilitate speedy trade license registration and renewal services for businesses.¹⁴

Some of the major changes in the Code include legal recognition of holding companies and single member companies, as well as allowing virtual shareholder meetings. The Code also introduces a variety of insolvency procedures in addition to bankruptcy, including preventive restructuring proceedings and simplified reorganization proceedings. Furthermore, it incorporates new clauses that provide protection for minority shareholders on corporate transparency and

¹⁰ <https://addisfortune.news/news-alert/parliament-passes-commercial-code-unanimously/>

¹¹ <https://newbusinessethiopia.com/trade/new-commercial-code-of-ethiopias-implications/>

¹² <https://addisfortune.news/parliament-amends-six-decade-old-commercial-code/>

¹³ <https://www.press.et/english/?p=32358#>

¹⁴ <https://www.fanabc.com/english/house-unanimously-approves-revised-commercial-code-of-ethiopia/>





disclosure, improved rights, and more stringent stipulations of responsibilities on the part of corporate boards.

4. Ethiopian Government introduces “franco-valuta” to contain galloping inflation

On April 15, 2021, the Ministry of Finance and Economic Cooperation announced that basic food commodities could be imported on franco-valuta basis to narrow the supply-demand deficit and reduce rising inflation in the country.¹⁵ Franco-valuta is an import trade arrangement where importers are permitted to use their own sources of foreign currency to import goods without having to access foreign currency through banks, i.e. without having to get Letter of Credit from banks in the case of Ethiopia.

In the statement issued on the matter, the Ministry stated that food commodities, including edible oil, sugar, rice, wheat and milk for children, can be imported on franco-valuta basis in the coming six months. Previously, the privilege of franco-valuta imports was given as an investment incentive only to manufacturers who import raw materials and equipment with the aim of promoting exports and substituting imports.¹⁶ However, there were also a few past episodes where the Government had to introduce similar measures to curb shortages of basic commodities in the economy.¹⁷ In the current episode, the Government has announced that anyone who has the equivalent amount of US\$250,000 can import the basic commodities without opening the Letter of Credit (the main payment processing method for imports in the country).

The franco-valuta system is a short-term effort to alleviate the challenge of galloping inflation in the economy in particular food price inflation. According to the Central Statistical Agency (CSA), the general inflation in the first three months of the year 2021 stood at 20.4, 20.3 and 20.4 percent, respectively whereas food inflation in these three months period was recoded at 23.2, 23.0 and 22.6 percent, respectively¹⁸.

¹⁵ <https://www.ena.et/en/?p=23628>

¹⁶ https://unctad.org/system/files/official-document/iteiia20042_en.pdf

¹⁷ <https://www.press.et/english/?p=33732#>

¹⁸ <https://www.thereporterethiopia.com/article/ethiopia-resorts-franco-valuta-basic-goods-import#:~:text=The%20Ethiopian%20government%20announced%20that,of%20living%20in%20the%20country.>





A few major underlying causes can be identified for the galloping food price inflation. The first one is lower agricultural production in the economy over the past two years due to conflict, instability and the worst locust invasions in decades in parts of the country. Injection of money into the economy (chiefly through government expenditure) that has not been accompanied by increased production in the economy is also a likely major cause. The third major cause is the worsening hard currency reserve of the country since the country is heavily dependent on imports of foodstuff.

The Ethiopian Government frequently intervenes to stabilize prices of basic commodities such as foodstuff. However, the normal means through which it attempts to stabilize prices had been through direct import of the basic foodstuff, which it then distributed at reasonable or subsidized prices. For instance, such measure was part of the Government's efforts to reduce the socioeconomic impact of COVID-19 pandemic last year. Therefore, the introduction of the franco-valuta system to fight food price inflation is also a major sign that the hard currency reserves of the country are in a worse situation compared to previous periods. The reasons for this include the halt in inflow of international tourists and reduction in inflow of worker remittances due to economic slow-down across the world due to COVID-19. Tourist inflows and worker remittances were two major sources of hard currency earnings for the country.

Inflow of foreign direct investment into the economy has also declined substantially due to the serious security situation in parts of the country and election related uncertainties among investors and the business community thereby limiting another important source of hard currency inflows into the economy. Moreover, there has been significant rise in commodity prices in global markets.¹⁹ Since Ethiopia covers a major share of its food needs such as grains through imports, there is also a major risk of imported food price inflation.

Unfortunately, the short-term outlook in relation to food price inflation and hard currency shortages in Ethiopia looks bleak as it is unlikely for any of the underlying causes and challenges to be easily resolved. The newly introduced franco-valuta system is also not expected to have a major impact in addressing the galloping food price inflation in the economy. In fact, the measure can be considered more as a signal

¹⁹ <https://www.theindependent.co.zw/2021/05/07/commodity-driven-imported-inflation-fears-unpacked/>





pointing to a serious underlying problem of hard currency shortages rather than an effective remedy even in the short-term.

5. Minimum capital requirement for banks more than doubled

On April 12, 2021, the National Bank of Ethiopia (NBE) issued a directive that has increased their paid-up capital to five billion Birr.²⁰ This has more than doubled the minimum capital threshold, revising the existing directive issued in 2008. It is the second amendment after the minimum capital requirement was increased two years ago to two billion Birr. Commercial banks in business have four years to increase their paid-up capital to five billion Birr. Banks under formation that have already raised an equity of over 500 million Birr from the public are required to comply with the new directive in seven years. It is likely for the regulator to force those banks that are unable to meet the minimum capital requirement by the end of the deadline to merge with others.

It is to be noted that there are 19 banks currently operational (17 private and two state-owned) in the country, while several others are under various stages of formation. As of now, only 3 out of the 17 operational private banks fulfil the 5 billion Birr minimum capital requirement (Awash, Dashen and Nib).²¹ Amhara Bank, which is about to join the financial sector shortly, also fulfils the criteria already.

The rationales generally given by NBE for the periodic increase in the minimum capital requirement for banks include ensuring that entrants to the sector are able to compete with well-established banks and “as banks expand their business they must maintain a level of capital commensurate with the volume of their business to withstand adverse operational results”.²² Even if not stated by the central bank, the fact that the Birr has been devalued by about 50% over the past three years means that the minimum capital requirement in Birr needs to be increased by 50% just to maintain its value the same in terms of, say, US\$ compared to three years ago. An additional justification includes small local banks with inadequate paid-up capital could not effectively compete and survive when the country eventually allows entry of foreign banks.

²⁰ <https://addisfortune.news/breaking-news/central-bank-increases-minimum-paid-up-capital-to-5b-br/>

²¹ <https://www.ethiopianreporter.com/article/21829>

²² <https://nbebank.com/wp-content/uploads/pdf/directives/bankingbusiness/sbb-50-11.pdf>





In fact, one of the major issues of contention in the accession process of Ethiopia to the World Trade Organization has been the country's hesitance to liberalize the sector and allow entry of foreign banks arguing (quite justifiably) that local banks are not capitalized and strong enough to withstand competition from multinational banks. Overall, it appears that the Government intends to limit proliferation of large number of weak and small banks which could lead to unhealthy competition amongst themselves while at the same time making them unviable once sector is opened for foreign competition.

While the rationale behind periodic increase in the minimum paid-up capital of banks has merit, one should not make a mistaken conclusion that 'bigger is always better' with respect to size of banks. In fact, the focus of regulators and policy makers should be on overall strength and health of the financial sector and the constituent banks, their efficiency, resilience, etc. As long as they are run efficiently, transparently and have strong internal capacity and systems, smaller banks have significant advantage over larger ones in economies such as Ethiopia's where the private sector is dominated by small and medium enterprises.

Globally, there is sufficient evidence that, if left to their own devices, larger banks either overlook or under-serve smaller businesses, despite the fact that in aggregate, small and medium-size enterprises (SMEs) are the largest employers in many countries.²³ Moreover, large lenders tend to prefer transactional lending and maintain an arm's length relationship with their borrowers and thus prefer large transparent borrowers, while small banks are good at relationship building and thus focused on smaller firms. Also, big banks usually do not have the local knowledge to know if an SME is a good investment or not.

A good example where the banking sector is not dominated by few big banks is Germany where it is said that there are 1500 'Sparkasse' local banks, which lend overwhelmingly to SMEs.²⁴ Note that Germany is the second biggest exporter in the world, and over half of those exports come from SMEs; and that would not have been possible without local banks lending for productive investment. The policy lesson from the forgoing discussion is that we cannot expect sufficient financing for small firms from a highly concentrated banking systems consisting only of a few large banks.²⁵ Therefore, having a diverse and decentralized

²³ <https://www.investorchronicle.co.uk/education/2020/12/30/further-reading-large-banks-fail-small-businesses/>

²⁴ <https://sourcenews.scot/small-businesses-are-suffering-and-its-the-banking-system-thats-the-problem/>

²⁵ <https://www.sciencedirect.com/science/article/pii/S0261560620302370?via%3Dihub>





banking sector that includes a large number of small banks could help overcome growth constraints on small and micro businesses like most businesses in Ethiopia.

6. Ever-increasing import cost of chemical fertilizers

It was reported on April 10, 2021 that this fiscal, year Ethiopia is spending 27.2 billion Birr (over US\$660 million in the current exchange rate) to import 1.8 million tons of chemical fertilizer.²⁶ Of the total amount US\$ 270-million-dollar is financed with a loan from the Eastern and Southern African Trade and Development Bank (TDB). According to the report, the quantity of fertilizer to be imported has increased by about 25% compared to the last fiscal year. This follows the consistent trend observed over the past three decades where, the quantity imported increased from 140,000tn in the 1990s and to 1.4 million tons during the last fiscal year.

Agriculture is critical sector in the Ethiopian economy as source of livelihood for the majority of the population, its contribution to GDP and as source of export earnings. For instance, over the current fiscal year, agriculture generated two-third of the export earnings of the country.²⁷ Fertilizers are critical inputs for the agricultural sector even if, to date, their use in the country is quite low compared to other countries, which is one of the major reasons for low productivity of the agricultural sector in Ethiopia.

However, the complete import-dependence of the country for its need of chemical fertilizers poses serious challenges to the economy. For one, the import of this single commodity costs an equivalent of more than a fifth of the total hard currency earnings from exports of the country. Secondly, the international price for chemical fertilizers is highly variable – in some years increasing by up to 40 percent. Thirdly, the government considers fertilizers as top priority import – a ‘political cargo’ as one senior official once put it²⁸ - since “a failure to import the much-needed fertilizer would adversely affect Ethiopia's overall security, as far as igniting public uproar against the Ethiopian government”.

Therefore, the appeal of attempting to substitute imported chemical fertilizers by domestic production is obvious. In fact, the Ethiopian government launched the construction of Yayu Multi-Complex Industries project in 2011 at an estimated cost of US\$ 540 million. The mega project under the Chemical Industries Corporation (a state-owned enterprise), located 600Km west of Addis Ababa in Yayu district, Illubabor zone of Oromia Regional State, is designed to manufacture 550,000 tons of fertilizers, 20,000 tons of

²⁶ <https://addisfortune.news/ethiopia-spends-over-660m-to-import-1-8m-tonnes-fertiliser/>

²⁷ <https://addisfortune.news/ethiopia-spends-over-660m-to-import-1-8m-tonnes-fertiliser/>

²⁸ http://www.xinhuanet.com/english/2019-10/18/c_138483605.htm





ethanol and generate 90MW of electric power annually using 9.2 million tons of coal.²⁹ It was also planned to create 35,000 jobs. The Government, however, canceled the contract it had given to the then Metals and Engineering Corporation (another state-owned enterprise) in 2018 not only for delaying the project for several years but also for substantial cost over runs.

The status of the project is not clear. However, given the strategic importance of the project, putting in place strict, transparent and efficient project management systems and completing project seems of paramount importance for the Ethiopian economy. Moreover, the Government and its development partners need to make serious efforts to encourage and facilitate local and foreign businesses to invest in other similar projects in order to substitute imports; save precious hard currency reserves of the country; and to ensure adequate, reliable and lower-cost supply of this strategic commodity.

²⁹ <https://addisfortune.net/articles/metec-loses-another-mega-project/>

