Ethiopia in-depth:
Anatomy of a foreign exchange crisis

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As a country with a strong tradition of sovereignty, state-led development and proud cultural identity (including its own calendar), Ethiopia is less market-oriented than regional peers such as Kenya. For investors, this creates challenges: key sectors such as banking and telecoms are off-limits to private capital, there is no domestic capital market, and foreign investors are prohibited from using certain financial instruments.

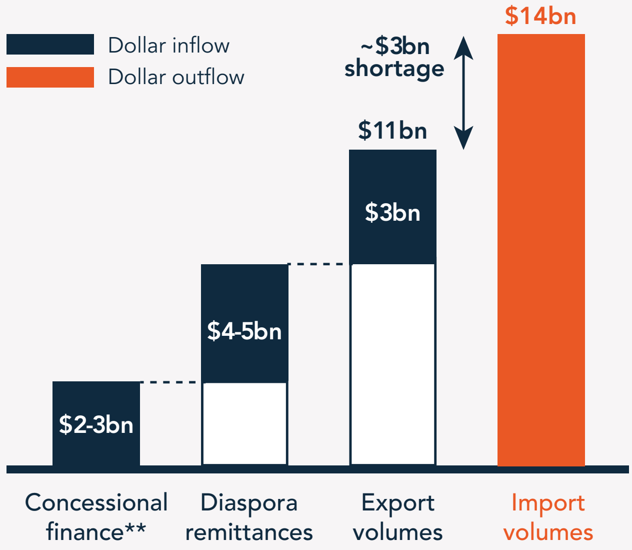
The greatest challenge, however, is the National Bank of Ethiopia's control over access to hard currency. As one investor observed to Sofala's team, "my worry is that if I make a profit in Ethiopia, I may have to spend every cent of it in Ethiopia."

Deconstructing the deficit

Ethiopia faces a severe trade deficit. To preserve scarce dollars for essential imports like food and petroleum supplies, the NBE rations access to dollars by the private sector. Each week, Ethiopia's 15 private banks submit a list to the NBE requesting allocations of forex: our research shows that current wait times for priority sectors such as healthcare, manufacturing and agriculture are 6 -7 months on average, while wait times for non-priority sectors can run to 2 - 3 years.

After a drop-off in traditional sources of hard currency such as coffee exports, the situation has worsened. In response, early this year the NBE directed banks to surrender 30% of their forex generated through day-to-day operations (previously banks had been free to allocate 100% of surplus forex to customers). As one investor stated: "it's a constant battle to get Letters of Credit approved […] it's really tough being reliant on fighting for dollars every month."

Ethiopia's annual trade deficit*



*All figures are approximate **For example, IMF loans and grants

Yet we believe the difficulties created by capital controls are manageable for investors willing to adjust their business model to the operating context. As one Addis-based manufacturing investor observed, "you can't invest in Ethiopia from the US or Europe, or from Nairobi for that matter; you have to be here, building relationships and getting creative with capital structures that work for this market." Another Ethiopian investor commented: "The forex issue can be solved as long as you don't tie yourself down with a rigid fund structure where you're committed to exiting investments on a fixed timeline; better to set up as a permanent capital vehicle […] Also, be prepared to take a 'venture building' approach, building up export-focused enterprises from scratch. There are few investable companies in Ethiopia, which makes brownfield investments hard; but on the upside, most sectors are growing fast and they're far less saturated than elsewhere, so this is greenfield country."

Categories of foreign exchange accounts

Non-resident Account

During the start-up phase, a foreign investor may deposit forex into a Non-resident Account and draw down on this amount to import capital goods, inputs, etc, provided these relate to the company's core business activity. There is no time limitation on use of funds and the account can be topped up.*

Foreign Exchange Retention Account A

When a company starts exporting, it is allowed to open a forex account to retain dollars locally for the purpose of importing raw materials. This account has two categories: under Account A, **30%** of export proceeds may be deposited. These funds can be held for an unlimited duration.

Foreign Exchange Retention Account B

Under Account B, **70%** of export proceeds may be deposited. These funds must be used **within 28 days** otherwise they will be automatically converted into Birr (at disadvantageous buyers' rather than sellers' rates)

*** Capital registration:**
Each capital injection must be registered with the EIC, as the investor's shareholding may later be evaluated by the regulator according to its cumulative registered capital contributions (for the purposes of allowing dividend repatriation, for example)

*** Dividended repatriation:**
This option covers retention and use of dollars in Ethiopia. However, to repatriate dividends, a company must (i) make a profit, (ii) declare a dividend, (iii) submit accounts to the NBE, and (iv) then seek approval from the NBE. Once these steps are complete, the company must wait in the queue for NBE approval (typically 6 to 7 months)

Longstanding investors in Ethiopia point to a range of options for addressing forex bottlenecks, including:

- Export-focused companies may retain forex generated from exports to purchase imported capital goods (see box), without having to wait in the central bank queue.
- Foreign investors may partner with an Ethiopian company that produces forex through its existing business.
- A Joint Venture can be beneficial even if the local company does not generate forex, as the Ethiopian partner can contribute its share of investment funds in local currency (Birr). In this way, virtually all overheads – salaries, vehicles, building materials, etc – can be paid for in Birr, thus preserving dollar funds for essential imports only, such as custom-built equipment and technology.
- A further option is to partner with one of Ethiopia's five Endowment Funds, each run by a regional party, as these reportedly enjoy easier access to forex. Peugeot has taken this approach in Tigray state, partnering with the Tigray endowment fund to build an ambitious new vehicle assembly plant.
- High profile, large-scale investors – such as manufacturers in the government's flagship $250mn Hawassa industrial park – may succeed in appealing directly to the Prime Minister's office and Ethiopia Investment Commission (EIC) to agree on tailored solutions.

Each investment requires a custom solution to the forex issue. As the corporate legal sector in Ethiopia is small, and the 'Big 4' accountancy firms lack any presence in Addis, Ethiopia's private banks are often the best advisory partner. These banks are in constant dialogue with the NBE and the leading players – such as Zemen Bank – have strong corporate banking teams with experience of advising global firms.

Risk and reward

Capital controls have deterred many would-be investors from Ethiopia, but we take a contrarian view. The problem is solvable, and for investors able to establish a footprint in the market today, the long term rewards could be significant.

Ethiopia is the fastest growing economy in the sub-Saharan region. With a population of 100 million, the country boasts the largest addressable market in eastern Africa; and with the Grand Ethiopian Renaissance Dam (GERD) coming onstream next year – the project will generate $1 billion in forex annually – the dollar crunch is set to ease.

In the coming years, we expect new sectors to liberalise or part-liberalise. Early indicators include the opening-up of the leasing sector to external investors, and the readying of large-scale state projects – such as the Yayu fertiliser project – for open tender to the private sector. We understand that even Ethio Telecom, the monopolistic state-run telco, may consider sub-contracting some operations to private service providers to help modernise and boost performance. As this trend gathers pace, investors with an established portfolio in Ethiopia are likely to attract premium bids from global multinationals for whom the previously closed Ethiopian market has become too big to ignore.

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