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Breaking the Black Market: The Case for Legalizing Foreign Exchange Trading in Ethiopia

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Abstract
The foreign exchange black market has been a significant challenge in Ethiopia, affecting the country's foreign exchange reserve, import, and export activities. The Ethiopian government has implemented various measures to curb this problem. However, they have only partially practical. Legalizing the foreign exchange market in Ethiopia could be a viable solution to the problem of the black market for foreign exchange. These would bring the foreign exchange market under government control, increase the availability of foreign currency, boost economic growth, and create more jobs. However, the government must ensure that the market is adequately regulated to prevent illegal activities and that all transactions are conducted transparently and accountable. By looking to other countries that have successfully legalized their foreign exchange markets, Ethiopia can develop a successful model for regulating its market.
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1. Introduction

The black market for foreign exchange trading has remained a chronic issue in many nations worldwide. Foreign currencies are traded outside the official exchange rate on the "black market," an illegal or unregulated market. These types of transactions cause capital flight, inflation, and economic instability (Campanella, J., & Martínez-García, E, 2018). This article will argue that legalizing foreign exchange trading can help to break the black market and promote economic growth.

Over the past few decades, several nations have tried to legalize foreign exchange trading with varied degrees of success. For instance, in Argentina, the government removed limitations on foreign currency exchange in 2015 (Dornbusch, 1986). These resulted in a rapid rise in the peso's value and a decline in the black-market premium. Similarly, Egypt's central bank floated the Egyptian pound in 2016, which contributed to the eradication of the illegal foreign exchange market (McCauley, 1979). On the other hand, some countries have struggled to legalize foreign exchange trading effectively. In Nigeria, for example, the government lifted restrictions on foreign exchange trading in 2016, a shortage of foreign currency and restrictions on capital flows have led to a persistent black market for foreign exchange trading.

Legalizing foreign exchange trading has a number of advantages for an economy. Firstly, bringing foreign currency transactions into the formal banking sector can promote transparency and lower corruption. As more people and businesses have access to formal financial services, this can also assist to promote financial inclusion. Second, legalizing foreign exchange trading can aid in reducing volatility and stabilizing exchange rates. When foreign exchange transactions are carried out on the black market, exchange rates might experience significant volatility that can cause the economy to become unstable. Governments can contribute to reducing this volatility and fostering economic stability by legalizing foreign exchange trading. Third, by increasing the inflow of foreign currency into the economy, allowing foreign exchange trading can aid in fostering economic growth. These can stimulate foreign investment, finance imports, and advance global trade (Campanella, J., & Martínez-García, E, 2018).

In Ethiopia, the Ethiopian government has implemented a managed floating exchange rate regime since 1992, which allows the Ethiopian Birr to be determined by the foreign currency market. Despite the government's effort to stabilize the Birr, the country's black market activities have been on the rise, particularly in the foreign currency market. The initial factor that contributed to Ethiopia's black market's rise was the country's economic instability. Economic instability in Ethiopia has resulted in high unemployment rates and inflation. The declining economic performance resulted in high demand for foreign currency resulting from the local currency losing value due to high inflation rates and slow economic growth. As a result, people try to buy foreign currency on the black market, increasing unlawful foreign currency transactions (Asgedom, 2019).

Secondly, lack of access to foreign currency is considered another factor. In Ethiopia, foreign currency transaction is tightly controlled by the government. Only authorized banks and financial institutions are allowed to conduct foreign currency transactions. However, due to the limited availability of foreign currency from authorized banks, individuals and businesses resort to the black market to obtain foreign currency. Furthermore, the government's decision to restrict foreign currency access to specific industries has created an uneven distribution of foreign currency, leading to black market activity (Demeke & Aragaw, 2020).

Political instability is also the main factor in the rise of the black market. Political instability creates uncertainty and decreases foreign investment in a country, leading to a shortage of foreign currency. Ethiopia has experienced political instability recently, including protests and ethnic conflicts. The political instability has contributed to a decline in foreign investment and exchange reserves, making it difficult for the government to manage the exchange rate. Individuals and businesses resort to the black market to obtain foreign currency, leading to an increase in illegal transactions (Bariyo, 2018). Furthermore, the high demand for imported goods is another factor in Ethiopia's black-market rise. Ethiopia heavily depends on oil, machinery, and consumer goods imports. The high demand for imported goods leads to an increase in demand for foreign currency, which creates a shortage of foreign currency in the country. In response, individuals seek to purchase foreign currency on the black market, increasing illegal transactions (Bariyo, 2018).

2. Methodology

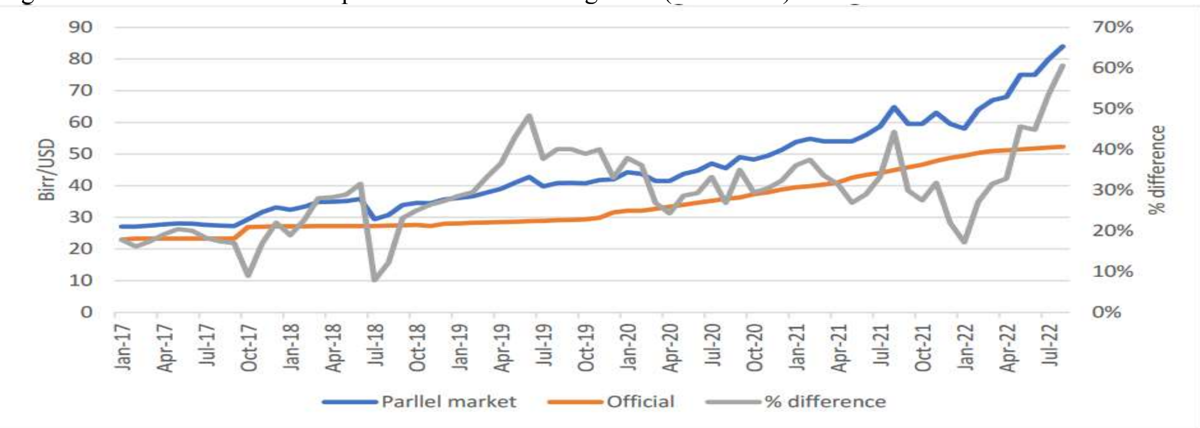
This rapid review article is based on a literature review of existing research on the black market for foreign exchange trading and the effects of legalizing foreign exchange trading. The literature review involved searching academic databases, such as the web of sciences, Scopus, JSTOR, EconLit, and Google Scholar, for relevant articles and publications using a combination of keywords and phrases, such as "black market," "foreign exchange," "legalization," and "economic growth. Simultaneously, various economic assessments on Ethiopia published by various organizations, such as the World Bank, the World Food Program, and the National Bank of Ethiopia, were utilized.

3. Discussion

Ethiopia is one of several developing nations that frequently experience the illicit market for foreign exchange. The Ethiopian government has not legalized foreign exchange trading by individuals, which has resulted in the growth of a black market where people buy and sell foreign currencies outside of government regulation. This practice significantly impacts the country's economy, including its foreign exchange reserves, as well as import and export activities.

As of September 2022, the official exchange rate between the Ethiopian Birr and the U.S. Dollar, guided by the National Bank of Ethiopia (NBE), was 52.52 Birr to the dollar, while the parallel market rate offered around 84 to 90 Birr to the dollar. As a result, during 2022, the official exchange rate of the Birr has lost 15 percent of its value against the U.S. Dollar, with the NBE implementing creeping devaluation between November 2019 and April 2022. Between August 2021 and January 2022, the difference between the official exchange rate and the parallel market rate decreased. However, since then, it has exhibited steep divergence, hitting 61 percent in August 2022. In mid-September, the Birr exchange rate slid to 90 to a dollar in the parallel markets in Addis Ababa and Togo Wuchalle, widening the gap between the official and parallel market exchange rates to a record 37 Birr or 71 percent. The Government crackdown on the parallel market narrowed the gap between the two rates to around 33 percent towards the end of September and October. However, the widening gap between the official and parallel market rates highlights Ethiopia's challenges in managing its foreign exchange reserves, controlling inflation, and maintaining macroeconomic stability. The following figure 1 of the study shows the official and parallel market exchange rate trends.

Figure 1: Trends of official and parallel market exchange rate (USD/ETB)



Source: WFP,2022. Note: The figure is directly taken from the report provided by the world food program report as of October 2022 regarding Ethiopia. Togo Wuchalle town, located in the Somali region 80 km away from the capital of Somaliland (Hargeissa), is a hotspot for the parallel currency exchange.

The widening gap between the official and parallel market exchange rates in Ethiopia highlights the country's challenges in managing its foreign exchange reserves, controlling inflation, and maintaining macroeconomic stability. One potential solution to this problem is to legalize the foreign exchange market in Ethiopia. These would allow individuals and businesses to legally buy and sell foreign currencies, bringing the foreign exchange market under government control. By regulating the foreign exchange market, the government can increase its revenue from foreign exchange transactions and ensure that they are conducted transparently and accountable. Countries like India and Brazil have successfully legalized their foreign exchange markets, providing Ethiopia with a blueprint for proceeding. For example, in India, the Reserve Bank of India regulates the foreign exchange market and sets the rules and regulations for foreign exchange trading. In Brazil, the Central Bank of Brazil regulates the foreign exchange market, which monitors foreign exchange transactions to ensure compliance with the country's laws and regulations.

Legalizing the foreign exchange market in Ethiopia would have several benefits. For instance, it would increase the availability of foreign currency in the country, making it easier for businesses to import and export goods. These, in turn, would increase trade, boost economic growth, and create more jobs. Additionally, by regulating the foreign exchange market, the government can reduce the influence of black-market traders, who often engage in illegal activities such as money laundering and tax evasion. However, there are also potential drawbacks to legalizing the foreign exchange market in Ethiopia. For instance, the government would need to ensure that the market is appropriately regulated and that all transactions are transparent and accountable. These would require the establishment of a regulatory framework, as well as the training of regulators and foreign exchange traders.

4. Conclusion

The black market for foreign exchange trading is a persistent problem in many countries, leading to a range of negative consequences for the economy. The factors contributing to the black market of foreign currency in Ethiopia include economic instability, limited access to foreign currency, political instability, and high demand for imported goods. Addressing these factors will require a coordinated effort from the Ethiopian government and other stakeholders, including increasing foreign investment, stabilizing the economy, and increasing access to foreign currency. Increasing the availability of foreign currency through export promotion and foreign direct investment, strengthening regulation and enforcement to prevent illegal forex trading, implementing policies to encourage foreign currency to be brought back into the formal banking system, and providing better access to foreign currency for businesses and individuals through licensed foreign exchange bureaus are some recommendations provided by others scholars. However, even though the regulatory authorities take those measurements, foreign currency transactions are worsening. This study highly recommends that the regulatory authorities consider legalizing foreign currency transactions in the country. By legalizing foreign exchange trading, governments can help to promote transparency, reduce corruption, stabilize exchange rates, and promote economic growth. While the experience of different countries with legalizing foreign exchange trading has been mixed, there is a growing body of evidence to suggest that it can be an effective policy tool for promoting economic development.

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