Trade Finance in Ethiopia: Exploring the Challenges and Possible Solutions[1]

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Executive Summary

The study aims to assess trade finance in Ethiopia, identify existing challenges and suggest remedial solutions. The study is based on desk review and analysis of survey data. Specifically, we collected data from 285 import and export firms and 18 commercial banks and the Development Bank of Ethiopia. The survey is designed to help us examine the extent of usage of trade finance in Ethiopia, the trade finance instruments used, the major obstacles to importing and exporting, the barriers to the growth of banks' portfolios in trade finance, how firms finance their trade, and the drivers of trade finance rejection as well as factors that contribute to high logistics costs and long dwell and lead-time for imports at seaports and dry port. The major findings of the paper are:

- ***Access and cost of trade finance is a major challenge for firms*****:** Both importing and exporting firms cite access to trade finance, in terms of delays and cost of getting trade finance, as one of the main challenges affecting their participation in the international trade and global value chain. Firms also echoed high collateral requirements, high commission fees, and limited grace periods as critical challenges in managing trade finance transactions.
- ***The trade finance application rejection rate remains high***. Our survey on commercial banks shows that the rate of rejection for trade finance is high, with close to 56% of banks rejected the trade finance applications by firms. Both firms and banks cite insufficient collateral, weak creditworthiness and foreign currency shortage as the main reasons why trade finance applications get rejected.
- ***Ethiopia's trade finance market appears to favor large firms***: Of the total importing and exporting firms surveyed, 44.5% report that they are discouraged from applying for loans. Out of this, about 60.2% of micro and 44.1% of small enterprises report that they are discouraged from applying for trade finance, compared to 36.7% of large firms. Surprisingly, the rate of rejection for trade finance application for large and micro firms are approximately the same (83% rejection rate) while out of 63.3% of application for trade finance by large firms, 52.6 % their trade finance application rejected by the banks, and 39.8% of micro firms applying for trade finance, 33.3% of their applications rejected.
- ***Alternative sources for trade finance***: firms look for alternative financing options such as drawing on their own funds, borrowing through informal channels, from their suppliers, or from

microfinance institutions. Hence, more than 40% of importers responded that they use their own funds for carrying out international trade. Again, more than one-third of exporters use cash-in-advance to engage in international trade.

- ***We found lower default rates on trade finance transactions:*** On average, the default rate on trade finance portfolios in Ethiopia is 2.5 and 3.6% in 2021 and 2022 respectively far better than the African average of 8%. The reason for default perhaps could be due to limited grace periods, high collateral requirements and the limited availability of foreign exchange means banks can pick on the safest transactions.

1. Introduction

International trade plays a key role in economic growth and development in many countries of the world, and the success of foreign trade relies on a sufficient flow of trade finance. Numerous studies establish that financial development and/or access to finance is an important determinant of firms' entry and export performance (see Abora et al., 2014; Greenaway et al., 2005; Kumarsamy and Singh, 2018; Jaud et al., 2014; Muuls, 2015). Moreover, the WTO estimates that between 80 to 90% of world trade depends on trade finance in the form of trade credit or insurance (WTO, 2017). Merely a small portion of international trade is paid cash in advance as importers generally wish to pay upon receipt of the merchandise to validate its physical integrity on arrival. Exporters, nevertheless, wish to be paid upon shipment. So as to bridge the gap between the time at which exporters wish to be paid and the time at which importers will pay, a credit or a guarantee of payment is required. Trade finance offers the credit, payment assurances, and protection required to enable the payment for the merchandise or service on terms that will satisfy both the exporter and the importer.

While conventional financing can be used to cover issues of solvency or liquidity, trade finance may be used as a guarantee against the unique risks that exist in international trade, such as currency fluctuations, political instability, issues of non-payment, or questions regarding the creditworthiness of one of the involved parties. Apart from facilitating payments across countries and mitigating associated risks, trade finance instruments are also used for raising working capital for importers and exporters. By giving access to critical liquidity and security to support the movement of goods and services, trade finance lies at the heart of the global trading system (Auboin and Meier-Ewert, 2008) and it can be considered a lubricant for international trade. International trade financing provides the necessary funding advances so that the exchanging of goods across borders is facilitated and the payment and supply risk that exporters and importers face is reduced significantly. An efficient trade financing system can improve productivity, competitiveness, and job creation – all of which stimulate sustainable development (Gonzalez, 2014).

Trade finance supports the process of structural transformation and economic development in developing countries by facilitating trade in goods and services and enabling firms to join regional and global value chains. Evidently, the importance of financial developments to foster export-led growth and import-substitution policies has been the hotspot of the literature. Following the influential contributions of Kletzer and Bardhan (1987) and Beck (2002) and subsequently, with the contributions of Manova (2012) and Chaney (2016), several authors have studied the link between trade finance and exports. The availability of adequate financing makes it possible for these firms to upgrade themselves to the required level and integrate into global value chains. Being part of the global production and distribution network leads to considerable developmental opportunities for businesses and a wide range of economic actors involved in the process (Gonzalez, 2014). The takeaway from this is that trade finance matters in facilitating international trade flows. Where provision is sufficient, it benefits trade (e.g. Auboin et al 2016), and where it is insufficient, it will hurt trade (e.g. Amiti and Weinstein 2011).

Studies identify Ethiopia's logistics sector as one of the constraints that drags the performance of the trade sector and a potential challenge in attracting quality FDI. Alongside transportation and logistics, lack of access to trade finance is one of the key challenges to exploiting Ethiopia's trading potential (World Economic Forum, 2016). Furthermore, there is a considerable and enduring gap between the demand and supply of trade financing in Ethiopia.

Exporting firms fail to secure the funds they need to complete orders from their overseas buyers' after spending significant time and resources to develop export contracts or orders due to various internal and external factors. For instance, the rigid requirement of the commercial banks for serving the loans (e.g. collateral) or the loan processing period impedes access to export finance (World Bank Report Doing Business, 2014). Exporters face financial constraints to arrange cargo as per contract until shipment and submission of shipping documents for negotiation. In general, one of the common complaints of Ethiopian exporters is that they receive minimal support from their banks for export trade transactions (Mekibib, 2008: Kiros, 2010: UNCATD, 2010). The private sector in Ethiopia is severely affected by the shortage of foreign currency, which is affecting competitiveness. For example, unit production costs increased by around 20% for exporting manufacturers and production levels decreased by around 30% because of the shortage of foreign exchange (Lloyd and Teshome, 2018).

In the same vein, importers face difficulty in obtaining foreign exchange, particularly those that import goods for domestic sale or in non-priority sectors. This shortage of foreign currency leads to long delays in getting foreign currency to import materials and services and businesses do not always receive their full foreign currency request. This delay will take about 4-12 months for essential imports and up to 3 years for non-essential imports, which differ between the banks (Lloyd and Teshome, 2018). As a result of this, informal payments are likely to be made to accelerate access to foreign currency and the consolidated fee to open Letters of Credit, for a three-month term, in private commercial banks can be as high as 10.25% of the value on the LC (Ibid). There appears to be a lack of transparency in the allocation of foreign currency to importers. Firms that are more affected by the shortage of foreign exchange are also more likely to use innovative solutions to access foreign currency including non-resident (diaspora) foreign currency accounts and the parallel market. Anecdotal evidence also shows that the lack of access to trade finance and/or foreign exchange also forces importers to face high port dwell time and long lead time for imported cargo – undermining their competitiveness and hurting Ethiopia's logistics performance.

Although the government is striving to improve the services given and build the necessary infrastructures, identifying existing problems in the areas of trade finance and suggesting ways for further improvements in the system is still crucial. For example, while policymakers have been keen to tackle the challenges facing the trade finance market, a lack of evidence often undermines efforts to gauge the scale of the problem and develop appropriate policy interventions. To the best of our knowledge, no previous study has been done in this area that the and points to the higher costs and decreased availability of trade finance in Ethiopia.

In its homegrown economic reform agenda, the GoE recognizes the challenges and importance of addressing structural problems facing businesses. As part of this, a comprehensive National Logistics Strategy (NLS) has been developed to address the shortcomings and transform the country's international trade logistics. Among the 98 interventions identified in the NLS, establishing control procedures for bank transaction payments (intervention 63), establishing a financial support system for importers and exporters (intervention 67), and simple and effective payment system for seaport service (intervention 68) are closely related to trade financing and are the main focus of this study.

Taking note of the above background, this study will therefore investigate the various aspects of trade finance system in Ethiopia focusing on identifying the challenges and determinants of access to trade finance and the challenge it poses to the logistics sector. Specifically, this paper has the following objectives:

- Assess the existing trade finance instruments and examine the extent of trade covered by trade finance
- Explore the factors that contribute to the high bank transaction fees, high logistics costs, and delays;
- Identifying challenges and determinants of access to trade finance for businesses engaged in export and import trade

- Providing inputs for the establishment of a financial support system for importers and exporters
- Explore problems in the allocation of foreign currency and suggest ways of increasing transparency in the allocation of foreign exchange
- Come up with new and improved trade finance instruments based on the experiences of other LDCs and DCs.
- Explore policy options for improving access to international trade finance and propose remedial solutions that can reduce logistics costs and time.
- Propose a control mechanism for bank transaction payments and establish a simple and effective payment system for seaport service.

2. Data and Methodology

To achieve the above objectives, this study employs both a desk review of the relevant literature (studies, policy documents, reports etc) and an analysis of data collected from a firm as well as bank surveys.

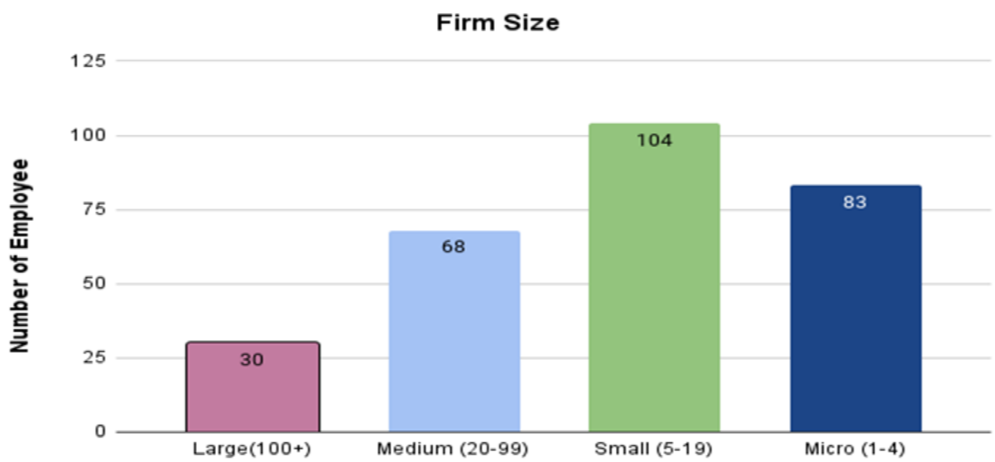
For the firm survey, the sampling frame was generated from a database of formally registered firms in Ethiopia. It covers exporting and importing firms from multiple sectors, including manufacturing, agriculture and retail enterprises. Sectors of operation were used to stratify the data. This was followed by a proportionate sample allocation across the different sectors based on the sectors' size within the sampling frame (see Figure 2-1). Simple random sampling was then used to select businesses from each stratum. The data is collected from 285 firms.

Numbers of permanent employees is taken as a measure of firm size.[2] Figure 2-1 below shows the average firm size of the surveyed firms by putting them in four categories. Large enterprises (with more than 100 employees) have the lowest share, constituting 10.5 % of total firms sampled. Medium-sized enterprises (employing between 20 and 99 employees) have the second lowest share (23.9%), while firms categorized as small (with a number of employees ranging from 5 to 19) and micro (employing less than 5 people) represent 36.5% and 29.1 % of total businesses surveyed, respectively. This is the same as a typical size composition of firms in other countries too, where more than 99.5% of firms are typically micro or small and medium-sized enterprises, also known as SMEs (Abe, *et al.*, 2012). This derives two issues for further data analysis: (i) the sampled firms well represent the population of firms in Ethiopia and (ii) with the first issue, the interpretation of survey results will produce reliable information for policy implications and recommendations.

[2] *[Question 1.8: Currently, what is the total number of employees in your enterprise (excluding casual workers)?]*

The firm-level information is supplemented with data collected from 18 commercial banks that provide trade finance to firms. While two of these banks are public banks (Commercial Bank of Ethiopia and Development Bank of Ethiopia), the remaining 16 are private banks.

Figure 2-1: Sampled firms by Size



Source: Authors' own computation based on the firm-level survey data.

3. Review of Literature

3.1. International Trade Finance: Concepts and Significance

Trade finance is an umbrella term for a variety of financial instruments that enable the successful conduct of cross-border trade of goods and services. It promotes international trade by helping firms raise working capital, facilitating payments, and mitigating risks due to information asymmetry and geographical barriers between importers and exporters[3]. Financing is required not only in the import-export process itself but also for the production of the goods and services to be exported, which often comprises imports of machinery, raw material, and intermediate goods. Lack of financing at any stage of the processes of production or export can stop the flow of transactions and potentially break up potential or even long-standing commercial relationships (UNCTAD, 2012). Trade finance guarantees increased international trade flows by bridging the information asymmetry between buyers and sellers and creating a trust-based system whereby, upon fulfillment of certain conditions, sellers receive payment for goods sold and buyers get the goods they paid for.

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[3] Toward Inclusive Access to Trade Finance Lessons from the Trade Finance Gaps, Growth, and Jobs Survey AUGUST 2022

Trade finance mechanisms provide a combination and degree of support in the following four areas (ITC, 2009):

1. ***Payment facilitation***: enabling secure and timely payment across borders, for example, through proven communication methods, such as SWIFT1[4] (a secure bank-to-bank messaging system used to transmit bank instruments, such as letters of credit, as well as payments between financial institutions).
2. ***Raising working capital***: financing to one or more parties in a trade transaction, whether it is the importer, exporter, or one of the banks.
3. ***Risk mitigation***: either directly through the features available in a trade financing mechanism or indirectly through insurance, trade finance guarantee products designed to meet the needs of importers and exporters.
4. ***Information***: providing information on the movement of goods and/or the status of the related financial flow.

Table 3-1: Matrix of trade finance instruments commonly used for raising capital, facilitating payments and mitigating risks

Raising working capital for exports: debt financing; asset-based financing; export factoring; and leasing
Facilitating payments: cash-in-advance; letter of credit (L/C); documentary collection; and open accounts
Mitigating risks: export credit guarantee; export credit insurance; forfeiting; and hedging.

Source: Adopted from Narain, S. (2016)

Trade finance considerably influences trade flows and its accessibility and provision help facilitate the stability of international trade. A number of studies confirm the significance of access to trade finance to international trade flows and economic growth. Higher trade credit fuels firms' output and exports (Van Biesebroeck 2014, Siregar 2010). Not only is trade finance associated positively with import and export volumes, but countries with access to external trade finance are also able to export more (Liston and McNeil 2013). Access to trade finance is also important for export orientation and internationalization of firms, specifically for SMEs to broaden their access to cross-border markets and improve their competitiveness (Pietrovito and Pozzolo 2019).

[4] Society for Worldwide Interbank Financial Telecommunication.

Trade finance is crucial to international trade and its widespread use is one of the factors that has contributed to the rapid growth of international trade. It plays an important role in the global economy, with the WTO estimating about 80% of global trade to be dependent on trade financing (UNCTAD, 2012). For instance, in 2020, the support provided by major global banks on the volume of trade finance transactions was estimated to be around $9 trillion and trade loans, letters of credit, and guarantees were approximated to be 90% of trade finance transactions Beck (2020)[5]. According to Asiedu-Appiah (2005), countries should devise a strategy aimed at trade financing schemes that put emphasis on exports, which generate earnings for their country, while making it possible for the country to purchase imports of its choice.

3.2. Trade finance Products and Instruments

Trade finance products can largely be put into five groups, namely: Export and credit agency (ECA) finance, Documentary trade finance (DTC), Structured commodity finance (SCF) and Trade credit insurance (TCI) (Global Trade Review, 2021)[6].

Export and credit agency (ECA) finance, which includes guarantees, loans and political and trade credit insurance provided by ECAs to promote exports by removing the uncertainty around export payments. ECA finance is, however, impeded by factors such as the limited availability of information needed for due diligence on SMEs in Ethiopia.

Documentary trade finance: a collective term used for traditional trade finance instruments that include letters of credit (LCs), guarantees and documentary collections.

Structured commodity finance (SCF): leverages the underlying cash flows of an asset, commodity or commercial off-take contract as security in providing a financing solution. Examples of this include warehouse receipt financing or revolving credit facilities.

Trade credit insurance (TCI): used in the event of credit risks such as bankruptcy or default, and political risk insurance (PRI)**,** used in the event of unforeseeable political circumstances.

[5] Steven Beck (2020) what is the Trade Finance Gap and Why Does it Matter?
Asia Regional Integration Centre

[6] *Global Trade Review, , link*

Supply chain finance (SCF): comprising either receivables purchase solutions (allowing supply chain parties to sell against all or part of their receivables) or loan-based solutions (whereby loans and advances are made against receivables). Usage of these instruments has been low historically, primarily due to high country risk perceptions.

3.3. Types and methods of payment

Importers should be able to perform transactions without paying exaggerated transaction fees for banks and they should find instruments that are secure and easy to use. There should be payment systems and procedures that importers can use and do not lead to unnecessary and costly delays at the ports. At the same time, it is important that exporters have access to the different payment methods that minimizes their risk of getting paid in full and on time. Exporters should not lose potential buyers by not having access to the different payment systems that may be convenient for their buyers – it will make them less competitive. In this section, we review the different types and methods of payment commonly used in today's world and see what is missing and what needs to be changed in the case of Ethiopia.

3.3.1. Open Account

This is the sale where goods are shipped and documents are remitted directly to the buyer, with a request for payment at the appropriate time which could be immediately, or at an agreed future date (Agbonika, 2015). This is the least secure method of payment and therefore only used regularly in low-risk markets. It is thus quite common in Western Europe and the USA. The seller will send the goods and all the documents directly to the buyer and trust them to pay on the agreed date (Jim & Jonathan, 2008).

3.3.2. Cash in advance/with order

It is the most common form of payment for trade involving small transactions. This method, also known as a pre-payment method, reduces the risk of not getting paid and provides the seller with a reasonable certainty of payment. The importer pays the exporter by using telegraphic transfer, international cheque or using credit cards before the exporter ships the goods. The parties may even agree on “cash on order” so that payment in fact precedes the sale or require credit transactions where large amounts of money are involved (Agbonika, 2015).

It is increasingly the case that overseas buyers in certain high-risk countries also accept it as the normal method of payment subject to their exchange controls. In this context, many African markets are regularly paying in advance. The money can be transferred just as for open account payment, the only difference being that the transfer takes place before shipment (or even before manufacture) against a pro-forma invoice rather than a final invoice (Jim & Jonathan, 2008). In this way, a cash-in-advance payment can also be used to avail the necessary resources that the exporter needs to produce the export items.

3.3.3. Letters of credit (LCs)

An LC also referred to as a documentary credit, is a contractual agreement whereby a bank in the buyer's country, known as the issuing bank, acting on behalf of its customer (the buyer or importer), authorizes a bank in the seller's country, known as the advising bank, to make payment to the beneficiary (the seller or exporter) against the receipt of the stipulated document. It is a commitment by the issuing bank on behalf of the buyer that payment will be made to the exporter provided that the terms and conditions indicated in the LC have been met (Agbonika, 2015). It is the preferred mode of settlement between a buyer and a seller under the following circumstances:

- They are not well-known to each other.
- They are located in different countries and the seller is not sure of the creditworthiness of the buyer. The Letter of Credit is governed by the ICC rules defined in Uniform Customs Practice (UCP 600).

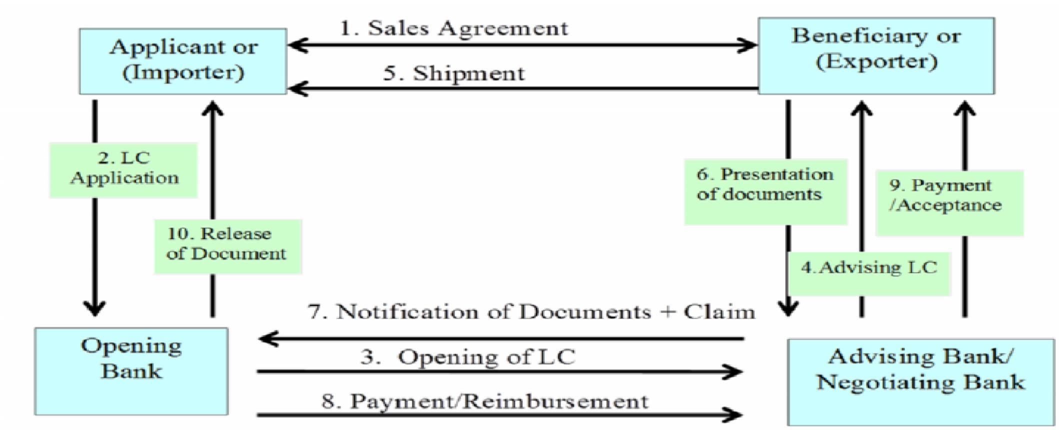
From a functional perspective Commercial Code of Ethiopia Art. 959 (1960), defines a Letter of Credit as a documentary credit, a credit opened by a bank providing for payment against the presentation of specified documents to the opening bank or to its agent. Goods represented by such documents may be held and disposed of by the bank in accordance with the terms agreed between the bank and its principal (p.208-209). Letters of Credit have been a cornerstone of international trade dating back to the early 1900s. They continue to play a critical role in world trade today. For any company entering the international market, Letters of Credit are an important payment mechanism that helps eliminate certain risks (Zsuzsanna, 2006).

The letter of credit calls for the participation of a third party, which is the bank. The bank provides additional security for both parties; it plays the role of an intermediary, by assuring the seller that he will be paid if he provides the bank with the required documents, and by assuring the buyer that his money will not be paid unless the shipping documents evidencing proper shipment of his goods are presented (Frida, 1996). In this way, the Letter of credit can be considered as the most secure instrument available to international traders; it protects both the buyer and the seller (ITA, 2023)[7]. The buyer pays his or her

[7] International Trade Administration (2023), Retrieved from https://www.trade.gov/methods-payment

bank to render this service. An LC is useful when reliable credit information about a foreign buyer is difficult to obtain, but the exporter is satisfied with the creditworthiness of the buyer's foreign bank.

Figure 3-1: How Letters of Credit works



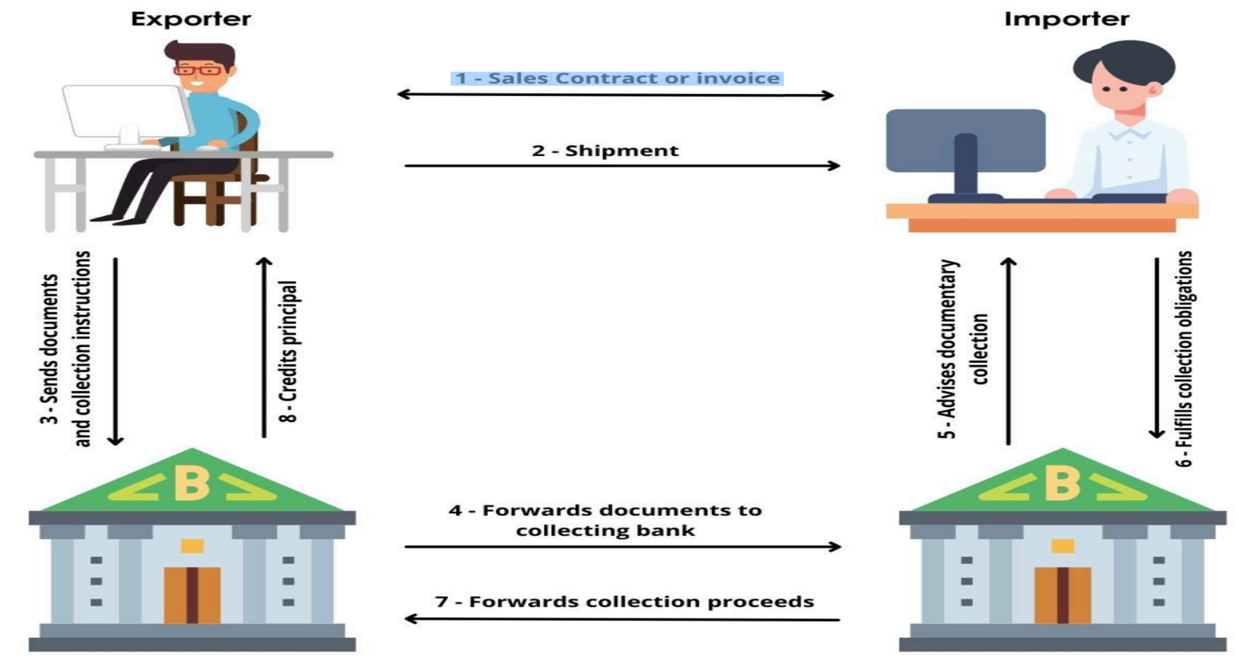
Source: Adopted from CITIGROUP (2004)

3.3.4. Documentary Collection (DC)

A Documentary Collection is a payment mechanism whereby an exporter uses the services of its bank (remitting bank) to obtain payment from an importer in exchange for the presentation of trade documents as pre-agreed in the commercial contract. DCs involve using a draft that requires the importer to pay the face amount either at sight (document against payment) or on a specified date (document against acceptance). The draft gives instructions that specify the documents required for the transfer of title to the goods. A Documentary Collection provides a compromise between open account terms and advanced payment terms in terms of risk to both the importer and the exporter. It is also a simpler and less expensive but less secure payment alternative to the Letter of Credit as it does not involve a verification process and recourse in case of no payment, the banks act as facilitators only and do not take credit or guarantee payment (see also ITA, 2023 and Citigroup, 2006 and Trade Finance Global, 2023[8]). DC is normally used when the importer and exporter have confidence in each other and/or that the importer is from an economically and politically stable country.

[8] Trade Finance Global (2023), "Methods of payment in trade finance: Trade Finance Global 2023 Guide". Retrieved from https://www.tradefinanceglobal.com/trade-finance/payment-methods/

Figure 3-2: How a documentary collection works



Source: Trade Finance Global (2023), "Methods of payment in trade finance: Trade Finance Global 2023 Guide". Retrieved from https://www.tradefinanceglobal.com/trade-finance/payment-methods/

3.3.5. Consignment Sale

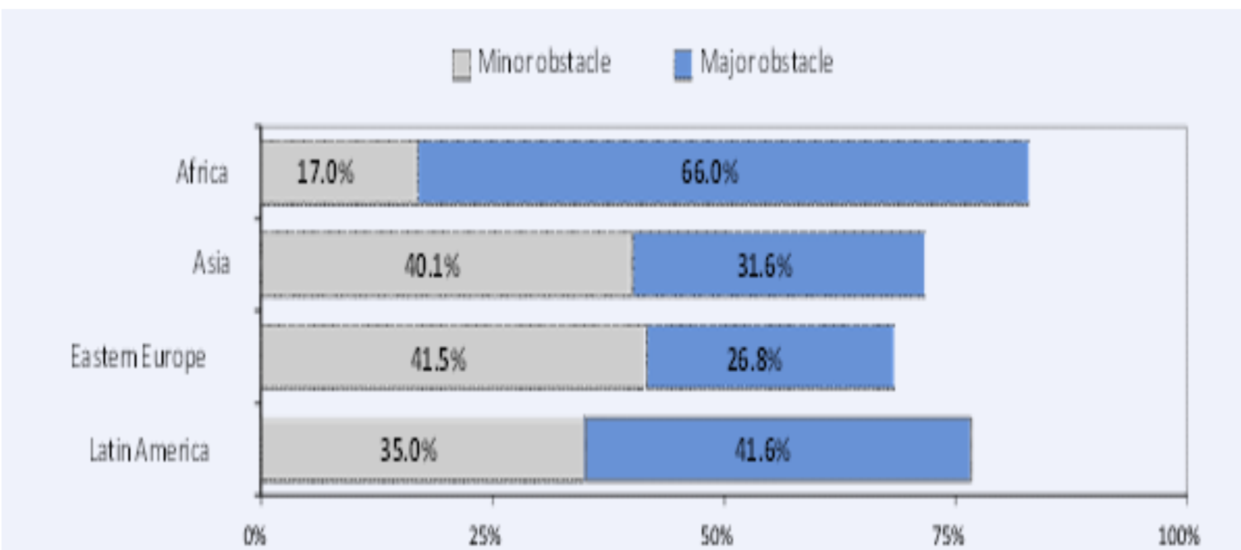
Under the consignment method of payment, the seller delivers the goods to his agent in a foreign land, who arranges for the sale of the goods and remits the payment to the exporter. The title to the goods remains with the exporter until the goods are sold to the ultimate buyer. Under this method, the exporter is not protected against loss that could rise if the agent or consignee fails to repatriate the proceeds to the exporter from the sale of goods (Cherunilam, 2006) and this method heavily relies on the availability of a trustworthy foreign distributor who can act as a consignee to the exporter.

3.4. Trade Finance in Developing Countries

Access to affordable trade finance is still one of the most problematic factors in developing countries, acknowledged by firms as hindering their growth and participation in international trade. Alongside transportation and logistics, lack of access to trade finance is found to be one of the top domestic barriers to a country's trading capacity (World Economic Forum, 2016). The trade financing gap is particularly evident in the least developed countries, where the financial sector has a tendency to be heavily transnationalized and strongly risk-averse. Tight credit conditions were driving up spreads for trade credits in many developing countries. Banks were increasing pricing on all trade finance transactions to cover higher credit risks as well as funding and transaction costs. The trade and finance problems of developing countries are almost unevenly heightened by financial, balance of payments and exchange rate instability as these countries tend to be susceptible to liquidity shortages and extreme risk aversion that characterize periods of crisis. During periods of shocks and crises, even the most creditworthy firms can find it difficult to access credit, demonstrating that financial markets are prone to significant failures (UNCTAD, 2012).

The lack of a sufficient trade finance infrastructure as a hurdle to trade is well documented in the literature (UNESCAP, 2005; Chauffour & Farole, 2009; Gregory et al. 2010). This is particularly the case for developing countries and more so for those in sub-Saharan Africa. A lack of access to trade finance is also a major problem for exporters, particularly SMEs, in developing countries (CBE, 2013). This report further indicates that 66% of the interviewed firms in Africa indicated access to trade finance as a major obstacle for their exports. This is significantly higher than the number reported for countries in Latin America (41.6%), Asia (31.6%), and Eastern Europe (26.8%) (see Figure 3-3). The CBE study further reveals that the domestic financial sector is often not able to back modern international transactions, such as trade receivables financing (Auboin, 2015).

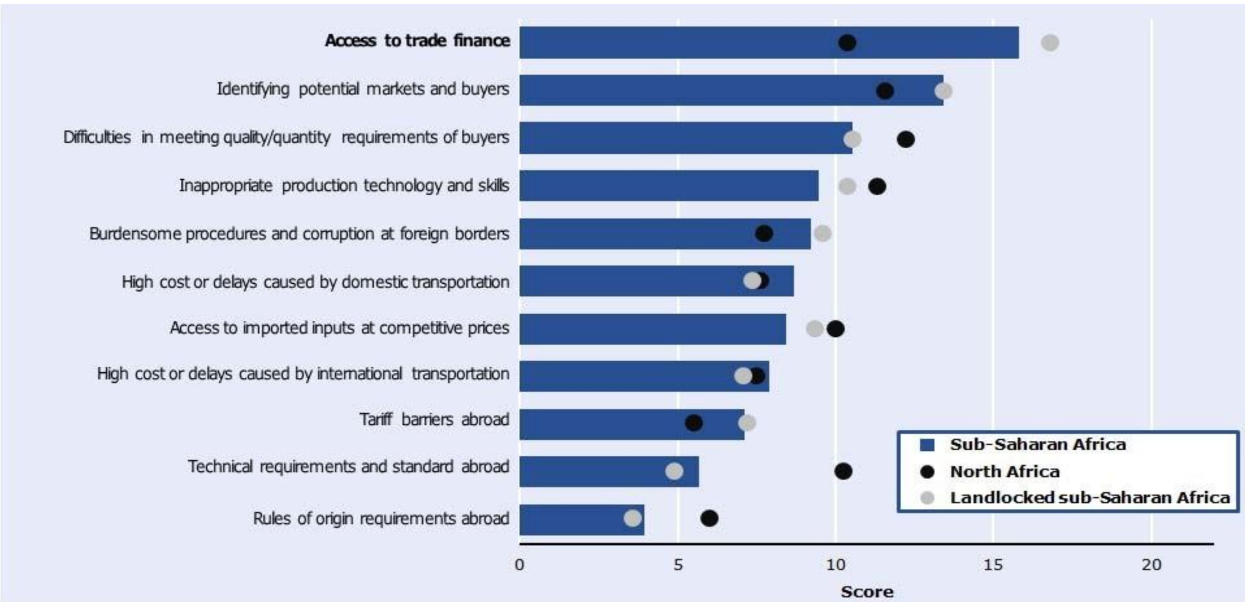
Figure 3-3: Extent to which access to trade finance forms an obstacle to company exports in developing countries, broken down by region



Source: *Auboin (2015)*

Similarly, the 2014 Global Enabling Trade Report of the World Economic Forum (WEF) ranked the lack of access to trade finance as one of the most problematic factors for exporting in Africa (see Figure 3-4). As can be seen from this figure, the problem is more serious for Sub-Saharan Africa and for landlocked Sub-Saharan African countries like Ethiopia. In general, trade financing is a major problem for African countries and the share of bank-intermediated trade in the region is relatively low. In the period 2011-19, only about 40% of the total continental trade in Africa was financed through Banks. This is relatively low when compared to the global average of 80% of global trade intermediated through banks.[9] Closing the gap in trade finance can thus facilitate sustainable development by creating jobs and enhancing productivity and competitiveness (Gonzalez, 2014).

Figure 3-4: Most Problematic Factor for Exporting in Africa



Source: World Economic Forum, 2014

3.5. Trade Finance Landscape: Potential Policy Solutions

The Addis Ababa Action Agenda of the Third International Conference on Financing for Development of the United Nations (UN) highlights sufficient trade finance as vital to attaining the UN's Sustainable Development Goals (SDGs). In recent years, the trade financing market has been transformed by a number of new initiatives and instruments globally. Bank payment obligations (BPO), for example, are a relatively new instrument endorsed by the International Chamber of Commerce (ICC) and SWIFT that serves as a bridge between traditional letters of credit and open account commerce. It eliminates paperwork and human intervention, but its use is limited (Ganesh et al., 2018). Other instruments have been developed, such as supply chain finance (SCF) and reverse factoring, which benefit both the buyer and the supplier business by optimizing working capital and minimizing costs and risk in the supply chain (OECD, 2015). A

[9] African Development Bank Group and African Export-Import Bank, Sept. 2020, "Trade Finance in Africa: Emerging trends and opportunities"

growing number of block chain-based platforms have recently been established. They offer a variety of approaches to support trade operations, ranging from digitizing documentation commerce to supporting open account trading (Ganesh et al., 2018[10]). Voltron, Marco Polo, WeTrade, Finacle Trade Connect, Easy Trade Connect, and eTrade Connect are all examples of recently developed platforms that have received backing from a variety of bank consortiums.

I. Warehouse Financing

The IFC recently established trade financing products as part of its Global Trade Finance Program. Warehouse finance products leverage production to offer working cash to small farmers and agricultural producers in food supply chains, while supply chain products provide short-term financing to exporters in emerging countries who sell to large international firms on open accounts. These encouraging developments have the potential to increase private sector participation in receivable financing, as well as in mobilizing extra trade finance and aiding the integration of SME exporters or producers into supply chains. Warehouse receipt financing, a type of collateralized commodities financing, is an important source of pre-export trade finance for emerging market agriculture. It is a lending method in which bank loans are extended to farmers, producers, and merchants of agricultural commodities in exchange for warehouse receipts issued against commodities held in licensed warehouses. A healthy warehouse receipt market requires a variety of requirements, including a suitable legal and regulatory environment, assistance from local banks and commodity enterprises, and a well-functioning commodities exchange that ensures price transparency. Since 2011, the Global Warehouse Finance Program has financed more than $7.5 billion in commodity finance transactions in 41 countries, including Burkina Faso, Ethiopia, Ghana, Guinea Bissau, Kenya, Malawi, Senegal, Tanzania, and Uganda. Private markets are also developing in order to make trade credit more accessible to SMEs.

II. Factoring

Factoring is a fastest-growing source of short-term finance for small and medium-sized businesses. Unlike typical loan arrangements, it enables suppliers with poor credit scores to access capital based on the value of their receivables (confirmed invoices). Factoring is utilized in international transactions and can be a useful financial instrument for mitigating the risks and uncertainties of international trade. Forfaiting, for example, is a financing tool designed for globally active enterprises in which an exporter sells his claim to trade receivables to a financial institution (the "forfaiter") and receives immediate payment, with the

[10] Ganesh, S. et al. (2018), *Rebooting a Digital Solution to Trade Finance - Bain & Company*, Bain & Company Brief, https://www.bain.com/insights/rebooting-a-digital-solution-to-tradefinance/ (accessed on 27 September 2019).

amount frequently guaranteed by the importer's bank. Several developing countries are advocating the use of factoring facilities to help smaller suppliers reap the benefits of supply chain finance. The "Cadenas productivas" (production chains) program in Mexico provides cash against receivables through a secure online platform. The Reserve Bank of India recently launched a "Trade Receivables Discounting System" or "TReDS" program similar to the Mexican model. The availability of international factoring arrangements, according to empirical studies, enables SMEs to participate in global value chains (GVCs) and trade globally (Auboin, Smythe, and Teh, 2016). According to empirical research, the availability of international factoring arrangements allows SMEs to participate in global value chains (GVCs) and trade globally (Auboin, Smythe, and Teh, 2016).

As a result, factoring is an especially suitable source of finance for businesses that struggle to obtain bank financing or whose creditworthiness is difficult or expensive to assess. This is true for SMEs that have an opaque or high-risk business model, rely largely on intangible assets that are substantially collateralized, or are very young and hence lack a track record. Given that the factor receives ownership of the underlying asset, the instrument may be useful in nations with limited creditor rights and/or an inefficient court system (Klapper, Udell, and Bakker, 2004).

3.5.1. International Best Practices

Cambodia

Cambodia has a legal framework for factoring, but its use is limited owing to tedious judicial procedures that make it difficult to liquidate assets. Furthermore, there are contradictory legal regulations governing secured transactions. Canada Bank PLC was the first financial institution in Cambodia to offer factoring in 2017. The FCI and the International Finance Corporation (IFC) co-hosted a symposium in Phnom Penh in 2017 to share international knowledge on factoring and assist local lending institutions, demonstrating an appetite for the technique (OECD, 2018).

Indonesia

Factoring within Indonesia is gaining momentum. In 2016, there were 29 leasing and two factoring companies in Indonesia, with a total factoring turnover of EUR 682 million (compared to EUR 40.6 billion in Singapore), with the majority (99.7%) being domestic. The majority of asset-based financing instruments are extended by multi-finance corporations, and these operations are governed by the OJK (Financial Services Authority). A collateral register was established in 2013, and as of 2018 (MacEachern, 2018), 580,207 SMEs had received loans secured by movable assets.

Lao PDR

The factoring market in Lao PDR is still in its infancy. The International Finance Corporation (IFC) has been engaged in promoting asset-based financing arrangements in the country, and in 2017 it hosted a workshop on the subject. The country's new framework for secured transactions, which includes an electronic collateral registry that was adopted in 2017, is likely to stimulate factoring activity among local enterprises.

Malaysia

Factoring is becoming increasingly popular in Malaysia. Total factoring volumes were less than EUR 2 000 million till 2017 but increased 170% year on year to EUR 4 459 million in 2018 (FCI, 2019). In 2018, there were 25 factoring companies in Malaysia. In 2018, domestic factoring activities dominated the market (98.4% of total volume). The Companies Commission of Malaysia (SSM) is using a legal framework for collateral registry to record security interests. Registration permits a secured creditor to make a claim on the movable property (which was used as collateral), which is then transparent to any other parties. A registry was established, which will function as a single electronic database including all information concerning existing security interests in movable assets and will be accessible to the public in real time.

Viet Nam

Since 2014, when volumes reached EUR 100 million, the factoring sector in Vietnam has grown rapidly. In 2018, the volume of factoring was EUR 1.1 billion. Following a period of moderate growth until 2012, this result is fairly impressive, with an average growth rate of 76.5% from 2013 to 2018. A legal amendment in 2012, paired with the creation of a new online registration, may have aided this expansion (MacEachern, 2018). Indeed, factoring can promote international trade by, for example, providing support for open account transactions. Although Vietnam has a strong regulatory framework for factoring, credit information is limited, which may stymie the growth of the factoring business (Huong, 2018). In 2016, there were eight official factoring service providers in Vietnam, three of which were members of Factoring Chain International (FCI). The International Finance Corporation (IFC) has been active in promoting factoring in Viet Nam, including through conferences and training sessions, in collaboration with Viet Nam International Bank (VIB), Factors Chain International (FCI), and Viet Nam Banks Association (VNBA).

3.5.2. Interventions needed to support the development of factoring in Ethiopia

Factoring is frequently regarded as highly relevant for SMEs in poor and middle-income nations. A critical enabling condition is reliable and accessible credit information, which is rare in Ethiopia. There is a public credit register, often operated by the national bank in Ethiopia, and a private credit bureau (non-existent in Ethiopia), which are two types of information-sharing entities. Both can alleviate the information gaps that are impeding the growth of factoring activities. These databases often contain information on on-time payments, late payments/arrears, defaults, bankruptcies on past contractual financial obligations, and so on (Boschmans and Pissareva, 2018). A collateral and accounts receivable register stands out as a particularly important tool for boosting the factoring business, and this tool is missing in Ethiopia. The information must be comprehensive enough for financial institutions to assess risk and assist SMEs seeking credit. Furthermore, in order to have the most impact, the registry should be notice-based, web-based, easily accessible, and with fair fees (MacEachern, 2018).

The regulatory framework is critical for the factoring business because it allows firms to sell accounts receivable to financiers in a secure manner. Furthermore, regulation can play a significant role in facilitating SMEs' access to trade finance instruments. This is especially true for new digital instruments, but it also applies to older trade finance assets, which can be greatly impacted by financial regulation and compliance difficulties. Excessive regulation leads to a concentrated market controlled by banks that may offer factoring as a supplementary service. On the other hand, regulatory loopholes may similarly delay market development, lead to legal problems and judicial battles, raise prices unnecessarily, and result in "adverse selection" (EBRD, 2019). In addition, the following regulatory issues have been identified as relevant (EBRD, 2019; FCI, 2019):

- The existence of a regulatory body supervising factoring companies and ensuing supervisory practices;
- The imposition of capital adequacy requirements for factoring companies;
- The inclusion on whether the re-assignment of the claim to third parties is allowed for or not;
- The overall efficiency, predictability, independence, and timeliness of the judicial system to facilitate the collection of receivables;
- Clear and standardized procedural rules in court settlements to drive down costs and expedite decision-making in case of disputes;
- Special procedures for speedy collection of undisputed claims;

In recent years, several emerging economies have established a central registry for accounts receivable, which aids the development of the factoring business. In India, for example, CERSAI, the Central Registry of Securitisation Asset Reconstruction and Security Interest, was established and it was mandated to cover the registration of security interests created through the assignment of accounts receivables or factoring. Every factor operating in the country is required to file receivables assignments, reducing the risk of fraudulent activity and uncertainty regarding ownership (World Bank Group, 2018). In 2007, China established its account receivables security interest register. This is a national registry with an online filing mechanism. It is easily accessible online, notice-based (no documents are required, and information is limited to the creditor, debtor, loan amount, and asset description), with reasonable fees, and all information is centralized in one place, and could thus be considered good international practice (IFC, 2012). The establishment or expansion of credit registries and bureaus has the ability to stimulate the market. According to World Bank research, 31 of the 34 OECD nations have a functioning credit bureau or credit registry (or both), with at least 5% of the adult population covered (World Bank, 2014). However, the regulatory and practical design of these entities differs greatly. There are significant disparities in the information provided by various institutions, such as past repayment information, the inclusion of balance sheet data, reporting requirements, and so on (OECD, 2012). Adopting best practices in this area would support Ethiopia. A noteworthy example is the Japanese Credit Risk Database (CRD). The database includes both financial and non-financial information, such as sales and profit data, information on investments and inventories, ratios such as operating and ordinary profits to sales, ratios expressing SMEs' net worth, and liquid, fixed, and deferred assets and liabilities. It also includes information on interest and labor expenses, as well as default information (three months or more in arrears, subrogation by credit guarantee firms, bankruptcies, and de facto bankruptcies) (Boschmans and Pissareva, 2018).

Public export credit agencies, particularly in high-income nations, frequently provide trade finance instruments to SMEs at the national level. In recent years, the purpose and scope of such bodies have come under question. Concerns have arisen, in particular, that these arrangements may result in unfair competition and a distorted level playing field, and that they should therefore follow some common rules (OECD, 2018). Nonetheless, when the trade financing market is disrupted, these groups, along with central bank facilities, can play a crucial role. Because trade finance assets have a short maturity, they must be quick to react (BIS, 2014). These programs are typically part of a larger package of actions designed to help SMEs reach global markets. More information on the Canadian experience in this area can be found in Box 1 below.Many programs that were started or expanded in the aftermath of the global financial crisis are still in place today. Well-known programs include the Trade Facilitation Programme (TFP) of the European Bank for Reconstruction and Development, the Global Trade Finance Program of the International Finance Corporation, the Trade Finance Facilitation Program (TFFP) of the Islamic Development Bank, and the Trade Finance Program (TFP) of the African Development Bank (WTO, 2018). Public trade finance can also help to standardize and embrace novel trade finance instruments like supply chain financing (SCF) and reverse factoring. For example, the Mexican program "Cadenas productivas" provides cash against receivables via a secure online platform. A comparable Trade Receivables Discounting System was recently established by the Reserve Bank of India (WTO, 2016).

Box 1. Canada's Export Diversification Strategy

In the context of mounting trade tensions, many governments have increased financial support to enable SMEs to become active in foreign markets. An example is Canada's Export Diversification Strategy, announced in 2018. A total of CAD 1.1 billion was invested to reach the objective to expand total exports by 50% or more by 2025. As part of the strategy, the government of Canada will invest an additional CAD 100 million over six years in CanExport, the five-year, CAD 50 million program launched by the Government in January 2016 to provide direct financial assistance to eligible Canadians, and related funding programs to support businesses looking to reach new overseas markets. In addition, non-financial support has been introduced and/or increased, such awareness-raising programs and export capacity-building initiatives for SMEs with the potential to enter or expand into international markets. Enhancing trade services for exporters and ensuring that Canadian businesses have enough resources to carry out their export plans is a critical component of the strategy.

Source: (Government of Canada).

3.5.3. Digitalization as an option to improve access to trade finance in Ethiopia

Digitization presents opportunities and has the ability to transform the trade finance market. Fintech firms, non-banks, and alternative financiers have the ability to reduce costs and expand market capacities, offering SMEs more options for risk mitigation when engaging in cross-border transactions (ITC, 2019). Distributed ledgers are an example of a technology that has the potential to improve the industry by lowering transaction costs while boosting trust and transparency in value chains (Ganesh et al., 2018). Border procedure innovation could also help lessen other barriers to SME internationalization. The complexity and cost of regulatory compliance at the border extend the time and money required to conduct foreign transactions, resulting in working capital shortfalls. Automation and procedure simplification can help to alleviate these constraints, particularly for SMEs (OECD, 2018). At the same time, the trade finance industry is frequently seen as being more reluctant to adopt innovative ideas than other financial sectors. This is due in part to the length of the trade value chain, which slows transformation and makes standardization more difficult (BNY Mellon, 2019). This may necessitate some form of policy involvement to ensure that the potential of digitization is fully realized and the hazards are adequately controlled. For instance, the Trade and Supply Chain Finance Program, in collaboration with the ICC and the Government of Singapore, launched the Digital Standards Initiative to develop digital standards and protocols. The program would create standards and protocols to promote interoperability among financial platforms and trade ecosystem components such as exporters, shippers, ports, customs, warehouses, banks/insurance, and importers. Interoperability/connections across supply chain stakeholders will also increase transparency by allowing "tracking and tracing" of component inputs along the supply chain. This will support efforts to ensure that supply chains are environmentally friendly, robust, adhere to labor standards, and are socially responsible.

3.6. Alternative Trade Financing Instruments

Trade finance is critical in enabling SMEs to engage in GVCs and trade globally. Diversification of instruments helps firms improve the market's resilience (BIS, 2014). Many Asian countries offer a variety of trade finance instruments, however application processes, particularly paper-based ones, can be discouraging for SMEs and entrepreneurs, and many applications are rejected. New digital trade finance instruments provide SMEs with more cost-effective and user-friendly processes. Industry-wide agreements may be required for them to be implemented effectively (BNY Mellon, 2019). The control of data is a critical subject in this regard. Increased digital trade necessitates the free flow of data across borders. At the same time, this matched with cyber-security and privacy goals (Casalini and López González, 2019).

The rise of e-invoicing in particularly Asian nations, as well as digital platforms for exporters and their commercial partners, are encouraging developments. Australia and New Zealand agreed on a collaborative strategy to promote the use of e-invoicing, which could serve as an example for developing countries. Australia and New Zealand have created a combined e-invoicing market by conforming to the PEPPOL Business Interoperability Specifications (BIS) for e-invoicing, a global and interoperable standard used by 34 nations, largely in Europe. Furthermore, public entities in Australia and New Zealand will pay their suppliers via e-invoices, acquainting them with the system. Government agencies in both countries also assist businesses in developing adoption timetables and paths to enable them to use e-invoicing for

B2B transactions. Another good practice is the "Networked Trade Platform (NTP)," which combines four government certification services essential for trading in and out of Singapore, as well as another 25 value-added services provided by third-party enterprises targeted toward trade, with more government organizations to follow. This platform promises to cut red tape for Singaporean enterprises with overseas operations. As an example, agricultural businesses can submit the relevant certificates and documentation digitally rather than in hard copy (The Business Times, 2018). Such approaches could be extensively adopted in Ethiopian circumstances.

Indonesia

Eximbank, a government-owned financial institution, provides financial instruments to SMEs looking to export (for example, export working capital finance). It also offers a variety of insurance products to manage risks for exporters and is a critical public support player for the country's internationally active SMEs (OECD, 2019).

Malaysia

Malaysia's export-import bank (MEXIM) is a fully government-owned export credit agency. It focuses on trade finance instruments in important industries such as capital goods, infrastructure projects, and high-value-added manufactured items. Its products encompass political risks (for example, Political Risk Insurance) as well as commercial risks (Risk Insurance) (OECD, 2019). In 2019, HSBC Malaysia developed the Supply Chain Finance Platform (HSCF), which allows for invoice interchange and supplier onboarding. It is intended to reduce costs and benefit SMEs in particular (Digital News Asia, 2019).

The Philippines

PhilEXIM (Philippine Export-Import Credit Agency) provides guarantees, export credit insurance, and loans to domestic enterprises, primarily SMEs. Infrastructure, agro modernization, and power generation are among the priority sectors (OECD/ASEAN, 2019[215]).

Singapore

To meet rising demand, the banking industry has greatly extended its provision of trade finance over the last 15 years. Singapore is an ASEAN Fintech hotspot due to its stable and accommodating regulatory environment and ease of doing business. Singapore was a pioneer in the use of Tradetech applications (for example, Tradeteq and Traydstream). Singapore's private equity climate is also fostering the growth of new Tradetech enterprises (E27, 2018[217]). The MAS's (Monetary Authority of Singapore) Financial Sector Technology and Innovation Scheme (UOB/EY, 2017) supports such projects.

Thailand

In a country where exports account for 70% of GDP (Deutsche Bank Corporate Bank, 2019), the Export-Import Bank of Thailand (EXIM Thailand) established export credit insurance, which was accompanied by buyer risk assessment (Thailand, 2019[220]). This instrument was created expressly for Thai entrepreneurs and SMEs to help manage international trade risks and encourage commerce in the face of rising trade tensions. Thai export credit insurance clients requested THB 87.5 million in compensation in the first five months of 2019. The insurance facility is accepted as collateral for loans by EXIM Thailand and other commercial banks. EXIM Thailand's Instant SMEs Export Insurance announced in 2016, involves a one-day application process. EXIM Happy Credit, which was introduced in 2018, provides SME exporters with a credit line (ADB, 2019). These initiatives appear to be fruitful. Thailand introduced a National Digital Trade Platform (NDTP) in 2019, as part of the Single Window Framework, a platform for a business-to-business information-sharing tool for importers, exporters, and other important business players, with the goal of increasing transparency, speed, and lowering costs. Following Singapore, the country adopted the e-Invoicing PEPPOL standard (Deutsche Bank Corporate Bank, 2019) (Dejvitak, 2019). The Thailand Blockchain Community Initiative was created in 2018 by 14 commercial Thai banks with the goal of applying distributed ledger technologies (DLT) to trade finance instruments in Thailand (Schellhase and Warden, 2018).

4. Trade Finance in Ethiopia: an overview

Recent economic growth in Ethiopia is largely constrained by severe shortages of foreign currency (forex). An analysis conducted by the Millennium Challenge Corporation, “Ethiopia Constraint Analysis Report 2020” identified the severe shortage of forex as a main impediment to economic growth in Ethiopia. Due to persistent shortage of forex reserves in the country, sectors of the economy and businesses that depend on imports experience lengthy delays characterized by idle and stoppage time, incurring losses and with most ultimately compelled to cease operations. This has certainly impacted the provision of quality trade financing services.

The current system of Ethiopia’s trade finance focuses on reducing the risks associated with maintaining foreign exchange reserves, limiting contingent liabilities associated with expenditures for imports and securing payments for exports. In the process, it limits opportunities for developing higher value export trades and reduces export competitiveness and the efficiency of import distribution. The principal constraints are the uncertainty of access to foreign exchange, the restrictions on terms of payment and the limited range of financial instruments available to importers and exporters, due primarily to regulations.

Ethiopia's current foreign exchange regulations allow payments for all imports of goods, except goods that are believed to be detrimental to the health of the public and the security of the nation.[11] Payments for imports can be made by letter of credit, cash against documents, advance payment, etc. Similarly, exports of goods and services are allowed through a Letter of Credit, Cash Against Document, Advance Payment, and Consignment payment methods. Small items of limited value and quantity are also allowed to be exported without foreign exchange repatriation requirements.

With a view to encouraging and supporting the export sector, the foreign exchange regime allows exporters to open a retention account and hold 20% of their export earnings in foreign currency indeterminately. Out of the total export earning, a deduction of 70% is made due to the surrender requirement and the commercial bank facilitating the transaction is allowed to retain the remaining 10% (Fxd. NBE 79/2022).

As per information gathered from NBE, the following facts are noted: -

- The Foreign exchange directive demands commercial banks not to allocate more than 50% of their foreign currency to items not listed under the new priority list of the NBE. The new directive intends to promote an efficient and fair allocation of the country's scarce forex resources.
- The NBE has not introduced regulations that would allow commercial banks to provide trade finance instruments. So far, the commercial banks took their own initiative in rendering pre-shipment services to exporters.
- The share of exporters and importers term loan disbursements during 2018/19, 2019/2020 and 2020/21 is very low. 7.4%, 10.3% and 15.7 % for **export** and 4.3%, 3.9% and 4.4% for **import,** respectively. The lending interest rate min./max. is 6.75/19% for export and 12.38/18.25% for import, respectively). On the other hand, Commercial banks Letter of Credit Service & opening Charges is 7.56% for Imports (NBE note).

As a working procedure, the National Bank of Ethiopia (NBE, FXD/77/2021) has set a foreign exchange allocation and priority list just to meet the above Ethio-Djibouti port utilization requirement which stated that the following foreign exchange sales are accepted on demand:

[11] This is apart from importation of the 38 products that are temporarily banned by the government on October 2022 as these are considered luxury and the country is facing sever foreign exchange shortage.

- Cargo handling, freight and other associated costs like container service, storage, port dues incurred on goods handled in transit by shipping and forwarding firms licensed to handle such services, and
- Payments for quality claims, loss in weight, commission, super intendancy or survey fee, and demurrage requests by exporters.

Although the above procedure is in place, service payments are delayed than the agreed time stated in the port utilization bilateral agreement. This resulted in holding Ethiopian Consignments by the Djibouti transistors until payments are effected. To address this issue, a Joint ministerial meeting had been deliberated in Djibouti from January 4-5/2014 and agreed to settle long outstanding payments as well as to respect the bilateral agreement signed in 2002. Accordingly, out of USD 5.6 million 66% of the payment has been settled. Further to the aforementioned, MOT has issued a comprehensive directive for the settlement of freight forwarding and auxiliary seaport payment (reference no. 2/2006).

The country's import cargoes lead-time from placing an order to delivery is very long. The main reason behind this is importers waiting time for foreign currency from commercial banks. Importers are subjected to excessive charges as a result of high bank fees paid to obtain bank permits and other related services. Lack of prompt transfer for predetermined transfer of sea port service charges is contributing to a very high dwelling time. High dwelling time means high progressive storage time and demurrage fines which are payable in foreign currency. Such high charges are not only affecting the importers but also escalating the national logistics costs ultimately. However, the settlement problem is still persisting, which calls for settling overdue payments. Therefore, an assessment should be carried out so as to set a swift transfer procedure and appropriate monitoring and evaluation mechanisms that can resolve the seaport financial settlement problems.

4.1. Instruments, Processes and Procedures to access to Trade Finance in Ethiopia

A bank's Allocation Committee represents the key decision-making body within commercial banks on foreign exchange matters and the membership of the Committees consists of the commercial bank's President and Vice President and senior management from the bank's International Banking Department (IBD). The Committee assesses and makes decisions relating to the bank's foreign exchange position and transactions while the frequency of Committee meetings varies across banks.

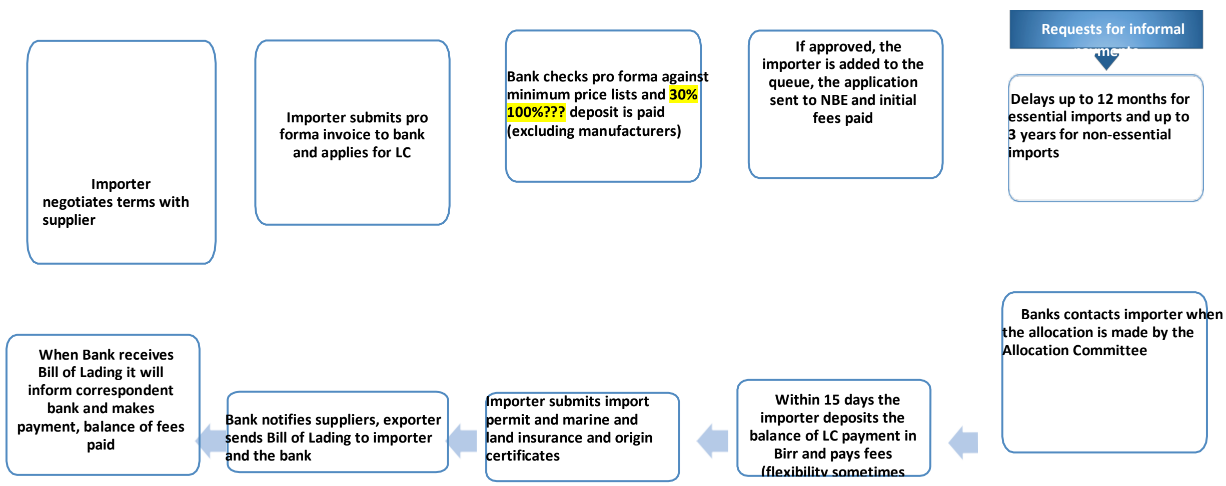
4.1.1. Application procedures by Firms for Trade Finance

There are several formal mechanisms to access foreign currency for businesses in Ethiopia. Businesses importing through these mechanisms should have (a) a current account with the bank they are using, (b) a valid trade license, (c) a valid tax identification number and (d) should not be reported as delinquent by NBE. The process for applying and getting access to trade finance differs in the type of instrument in question and this is discussed in the sections below:

4.1.2. Letters of credit

Letter of credit (LC) guarantees payment for exports or imports between the buyer's or importer's bank to the seller's or exporter's bank; and LC can be opened on a revocable and irrevocable basis. The process for application by businesses is similar for each type of LC. Figure 4-1 describes the main steps in the processes followed by banks and businesses in applying for an LC. The IBD notifies the importer of the availability of foreign currency once foreign currency is allocated to an LC.

Figure 4-1: The main steps undertaken by a business in importing through LC



4.1.3. Cash Against Documents

Cash against Documents (CAD) processes are the second most frequently used process in Ethiopia after LC. Businesses in Ethiopia are only advised to use CAD when they have a strong relationship with the supplier and under this process a commercial contract is agreed between the buyer and the seller and goods are shipped. Documents are then delivered from the remitting (exporter's) bank to the importer's bank, and then the client. The process for importing through CAD is similar to that used for LC, the major difference being that payment is effected once the documents are received by the local bank. A supplier or exporter that has sold to an Ethiopian importer through CAD presents the local bank with the documents consisting of (a) an original Bill of Lading, (b) a commercial invoice, verified by the Chamber of Commerce of the supplier's country, (c) a packing list and (d) a Certificate of Origin, verified by the Chamber of Commerce of the supplier's country. The process of CAD is administratively less complex than for LC although the delays in accessing foreign currency through CAD are the same as for LC and occur while the applicant is waiting in the queue.

4.1.4. Telegraphic Transfer

Although Telegraphic Transfers (TT) is available to businesses in Ethiopia, limits of US$ 5,000 per transfer make this mechanism unsuitable for most large-scale importing businesses. As such, TT are usually used to import small volumes of inputs or pay for consulting fees. Some private banks charge 4.5% for telegraph services. In Europe, by contrast, there are no limits on TT (only money laundering checks); maximum fees, for instance, at Barclays Bank (UK) are £40. The applicant undertaking a TT initially submits a pro forma invoice and application for TT. This is then registered on the bank's system and the foreign currency request is added to the bank's system and submitted to NBE; and the request will be delayed until an allocation of forex is made. Delays for TT are similar to delays for CAD and LC. When Forex is allocated for this payment, the documents submitted to the bank are (a) a signed and stamped import application form; (b) a pro forma invoice; (c) an insurance certificate; (d) a copy of valid foreign trade, investment, industry, agriculture or mining license; (e) a letter of undertaking for importation of goods; (f) a tax registration certificate; (g) an application letter for the transfer; (h) an original title certificate, for used vehicles, and a (j) third party original price confirmation certified by a Chamber of Commerce.

4.1.5. Retention and non-resident accounts

Retention and diaspora account holders are authorized to use the foreign currency held in these accounts for purposes restricted by foreign exchange Directives. For example, non-resident Ethiopian accounts are only permitted to import items related to the business license held by the account holder. Forex retention accounts held by forex generating businesses can be employed to import goods, (except vehicles), pay loans, pay tour operators, pay conference centres and pay consultants. Retention and diaspora account holders follow the same processes detailed when importing through CAD, TT and LC as other importers. As they are using their own foreign currency, businesses using retention accounts for imports are not registered, do not queue and their demands should be served on demand. NBE does not charge fees on LC, CAD and TT opened from retention accounts.

4.1.6. Franco valuta and supplier credit

After a business receives a Franco Valuta license from the NBE, it progresses import procedures through a local bank by submitting an application and shipping documents. Importers then make payments to suppliers from offshore foreign currency accounts. A service charge is levied by the banks, the amount being dependent on custom authority value estimation slips, and has changed between 2% and 1% of the value of imports in recent years. To utilize credit from suppliers, businesses must apply to the NBE. Applicants require local bank "advice," customs documents, and loan terms. Although the supplier credit directive is more flexible, NBE, in practice, only approves access to the supplier's credit if a company exports 100% of its product; the companies use their own foreign exchange to settle their payment to suppliers. Policymakers consider this mechanism a risk and hence do not actively promote its use because companies defer their foreign currency payments.

4.2. Foreign Exchange Management and Control in Ethiopia

According to the National Bank of Ethiopia, the country recorded a trade deficit of USD 5.43bn in the first half of 2021. The significant trade deficit and the limited forex generation obliged the country to strictly regulate the retention and utilization of foreign currency earned from various sources including export earnings and inward remittances. Transfers, holdings, and transactions using foreign currencies as a medium in Ethiopia can only be legally conducted through local banks and authorized dealers.

The National Bank of Ethiopia has sole authority to issue regulations on foreign currencies. The National Bank of Ethiopia Establishment (amended) Proclamation 591/2008 prescribes the conditions, limitations, and circumstances under which residents of Ethiopia, non-residents visiting Ethiopia or any other person, may possess and utilize foreign currency or instruments of payments in foreign exchange. Moreover, the terms and conditions for the transfer of foreign exchange to and from Ethiopia, the export or import of valuable goods, the transfer of valuable goods across the customs boundaries or frontiers of Ethiopia, the return of goods, and the settlement of any foreign exchange that results from export or import or transfer are determined by the National Bank directives. In addition to issuing directives, the National Bank also provides regulatory oversight of foreign exchange transactions of banks, insurance companies, and other financial institutions through on-site inspection and off-site surveillance.

Formulating and implementing exchange rate policy, managing international reserves and setting limits on the foreign exchange assets and the net foreign exchange position of banks is also the mandate of the National Bank of Ethiopia (NBE) (FNG 2008: 4172). Under the National Bank of Ethiopia's establishment

Proclamation, NBE is entrusted to closely control foreign exchange transactions. The Proclamation provides a wide-ranging authority and allows for (i) banning of transactions of foreign exchange except with banks or authorized dealers; (ii) imposition of terms, conditions and limitations under which residents and non-residents can possess and utilize foreign currency or instruments of payments in foreign exchange; (iii) imposition of terms and conditions for the transfer of foreign exchange to and from Ethiopia and the settlement of any foreign exchange that results from export, import or transfer; (iv) import or export of valuable goods or foreign exchange to be disallowed unless conditions, circumstances and terms determined by NBE are fulfilled; and, (v) monitoring of foreign exchange transactions of banks by NBE. In Ethiopia, foreign exchange regime has been liberalized only very gradually. The delegation of the management of foreign exchange operations to commercial banks under Directive FXD/07/1998 was one of the most important steps, this directive was later amended in 2019 as directive number FXD/63/2019. Since then, several foreign exchange Directives have been issued and complemented by numerous letters and guidelines. The following subsections will present the most relevant Directives.

4.3. Foreign currency directives: overview and analysis of recent changes

To date, the National Bank of Ethiopia has issued a number of directives governing various aspects of foreign currency control, retentions, utilization, management, and operations of foreign currency, foreign currency transactions, and regulations of external loans. The National Bank directives for retention and utilization of export earnings specifically delineate how much foreign currency deposits depositors are able to use and the manner in which they are allowed to be used. The National Bank directives for retention and utilization of export earnings issued in the late 1990s[12] remained largely unchanged for close to 20 years. In 2017, the National Bank of Ethiopia issued the Retention and Utilization of Export Earnings and Inward Remittances Directive No. FXD/48/2017, amending the directive issued in 1998. Recently, the National Bank of Ethiopia has accelerated the rate of issuing directives, where FXD/66/2020 was issued in September 2020, followed by three different directives, in less than a year and a half (FXD/70/2021, FXD/73/2021, and FXD/79/2022), and these are outlined in more detail below. The National Bank attributes the frequent amendment of the rules to the increasing demand on the country to cover repayment of loans, execution of the country's megaprojects and payment for imports of fuel and consumer goods.

- **Retention and Utilization of Export Earnings and Inward Remittances Directive No. FXD/11/1998**

[12] The retention and utilization of export earnings and inward remittances Directive issued in 1998, FXD 11/1998

A directive to amend the Retention and Utilization of Export Earnings and Inward Remittances Directive No. FXD/04/1998 was issued on August 31st, 1998, by the National Bank of Ethiopia. The directive prescribed that regular recipients of foreign exchange remittances from abroad and exports of goods and services are eligible to open retention accounts at commercial banks. There are two types of retention accounts that can be opened by eligible customers: (i) Foreign Exchange Retention Account A, and (ii) Foreign Exchange Retention Account B. The directive provides that eligible customers have the right to retain 10% of the export earnings and inward remittance in account A indefinitely, and 90% of the export earnings and inward remittance shall be retained within account B for 28 days. After 28 days it will automatically be converted to a local currency the next day unless it is utilized by the account holder. Under this directive, eligible customers had the right to utilize 100% of the export earnings and inward remittance within 28 days for business-related purposes including import of goods and related services, export promotion, advertisement, marketing, service payments for non-residents, training and education expenses, payment for settlement of external loan suppliers' credit, and other payments approved by the NBE.

- **Retention and Utilization of Export Earnings and Inward Remittances Directive No. FXD/48/2017 Amendment**

In 2017, the National Bank of Ethiopia issued the Retention and Utilization of Export Earnings and Inward Remittance Directive No FXD 48/2017. Similar to the previous directive, this directive allowed exporters of goods and services and recipients of inward remittance to open two types of foreign currency retention accounts (account A and B), but increased the amount allowed to be retained unconverted indefinitely in account A from 10% to 30%, and reduced the amount to be retained in account B to 70% (from 90% in the previous directive). After the lapse of the 28 days, the 70% foreign currency retained in Account B will automatically be converted to local currency by the account holder's bank using the prevailing buying exchange rate. With this arrangement, exporters and recipients of inward remittance can have full access to the foreign currency credited to their accounts within 28 days and utilize it for purposes enumerated under the same directive, mainly for export business-related purposes.

- **Transparency in foreign exchange allocation and foreign exchange management: Directive no. FXD/57/2018**

As the foreign currency shortage worsened, the NBE introduced foreign currency allocation requirements to direct foreign currency with the ambition of (a) maintaining the stability and credibility of the banking system and (b) enhancing transparency in foreign currency allocations. The 2016 and 2017 foreign exchange allocation Directives were amended a new Directive, FXD/57/2018, which was issued in

September 2018. As per the Directive, a bank's board of directors is required to put in place foreign exchange operations management guidelines that conform to NBE's Directives. Moreover, the Directive ensures bank records and the minutes of Allocation Committee meetings allow for an assessment of compliance with the guidelines, including up to date information on foreign exchange purchase requests and allocations made. Furthermore, the Directive distinguishes between foreign currency requests for essential imports, non-essential imports and requests for which foreign exchange must be sold on demand.

Accordingly, highest priority requests, that are exempt from registration procedures and where currency should be sold on demand, include: (i) foreign currency requests from foreign employees; (ii) external debt repayments and supplier credits; (iii) invisible payments (including payments to Ethiopian diplomatic missions, aviation services and licensed transit companies etc.); (iv) foreign exchange bureaux requests; and (v) foreign currency requests from non-resident foreign currency transferable Birr accounts, retention accounts and foreign currency accounts of non-resident Ethiopians and those of non-resident Ethiopian origin.

Second in line for foreign currency are essential imports; of the foreign currency allocated to imports by banks, FXD/51/2017 dictated that at least 40% must be directed to essential imports while the September 2018 Directive amended this to at least 50%. If the amount destined for essential imports is less than 50%, the difference should be surrendered to the NBE at the mid-rate. According to the Directive, foreign currency for essential imports should be registered and served on a first come first served basis thereafter within three levels of priority. The first priority consists of fuel and pharmaceuticals. The second priority includes input for agriculture and manufacturing. The third priority includes (a) motor oil, lubricants and gas, (b) agricultural inputs and machinery, (c) pharmaceutical products, (d) manufacturing businesses requests for procurement of machines, and spare parts (e) imports of nutritious foods for babies, (f) spare parts for construction machines, (g) educational materials; (h) profit and dividend transfer, (j) transfer of sales from foreign airlines; and (j) sales from the share and liquidation of companies from foreign direct investment (FDI).

The definitions of imported items were clarified under FEMRMD236/2016. Banks were required to report to NBE the registration queue numbers, approval dates and permit numbers on each permit copy; and banks were also required to give signed and stamped registration confirmation slips to applicants showing the queue number, registration date, name of importer, pro forma invoice number and pro forma invoice date and value. Banks were also required to (a) report queue numbers on a weekly basis, (b) notify applicants of an allocation within 3 working days of a decision by the allocation committee, and (c) send minutes of the foreign currency Allocation Committee meetings to NBE every time foreign currency is allocated. A cloud-based system was established in August 2018 which reports the queues to NBE daily, including new registrations and allocations made; and FXD/57/2018 requires banks to use this system.

The Directive also prohibits allocating foreign exchange from an exporter to an importer outside of the framework described. According to the Directive, manufacturers benefit by not needing to pay the full Birr amount of a purchase order, and they were required to pay only 30% of a letter of credit (LC) in advance. Moreover, a letter sent in December 2017 exempted horticulture producers and exporters, which import inputs, from the 100% deposit required when applying for foreign currency through Cash Against Documents (CAD).

The Directives also include several requirements of banks, including the prohibition of (a) declining a registration request from an importer, (b) restricting the number of applications or the value of these that a business can make and (c) making it a condition that importers accept other bank services. Directive FXD/53/2017 seeks to monitor the under-invoicing of pro forma invoices; and accordingly, banks were directed not to accept a pro forma invoice when prices for selected items are less than the minimum prices indicated by the Ethiopian Customs and Revenue Authority (ECRA) price valuation or obtained by banks from the international market. Banks submit pro forma and their alignment to minimum prices to NBE alongside their weekly submission of foreign currency applications.

- **Non-resident Ethiopians and Non-resident Ethiopian origin accounts, Directive no. FXD/55/2018**

The aim of this Directive was mainly to encourage non-resident Ethiopians to spend and save their foreign currency in Ethiopia. As such, the Directive allows individuals and enterprises that are non-resident Ethiopians (Ethiopian nationals living, or planning to live, abroad for more than one year) or non-resident foreign nationals of Ethiopian origin (non-resident foreign nationals with identification card attesting to the Ethiopian origin) to open foreign currency accounts in Ethiopia. According to the Directive, time deposit accounts, with a minimum maturity of 3 months or current accounts are allowed while interest is only payable, at a rate no more than the LIBOR, if the currency is retained in time deposit accounts for more than three months. Only Sterling, US dollar and Euro-denominated accounts were authorized, even if deposits are allowed in other currencies so long as these were immediately exchanged. Although initially current accounts were limited to holding 50,000 units of the account’s currency, this limit was removed in late August 2018.

Non-residents are required to submit documents confirming that they are, or are planning to, live and work overseas for more than one year (365 days), and that these documents are subject to renewal. Foreign currency is only allowed to be credited by the account holder with funds transferred or originating from the place of residence and NBE recently issued a letter stating that the names on the crediting and depositing accounts must match. The mechanisms for crediting include direct crediting from the place of residence and foreign currency cash deposits in Ethiopia, subject to the latter being accompanied by foreign currency declarations from ERCA. Accounts can be used to make foreign payments for imports, given that the account holder holds a business licence related to these imports. Eligible non-residents including diplomatic missions, individuals working for them and international organizations and their employees, are also able to open foreign currency accounts in Ethiopia. Non-resident foreign currency accounts are able to keep balances in foreign currency. And 100% foreign-owned businesses can open non-resident foreign currency accounts and use these for international payments and making payments in Birr locally.

- **Retention and Utilization of Export Earnings and Inward Remittances Directive No. FXD/66/2020**

In September 2020, the National Bank issued the Retention and Utilization of Export Earnings and Inward Remittances Directive No FXD/66/2020.The directive followed the same approach as its predecessor in allocating similar portions to the two current accounts (30% in account A and 70% in account B) and employed 28 days of conversion of the 70% balance in the current account B to a local currency. The new departures introduced under Directive No FXD/66/2020 were the listing of purposes against which the foreign currency under account A can be utilized and matters on the right of exporters and recipients of inward remittances to freely sell all or part of their account balance to Banks.

- **Retention and Utilization of Export Earnings and Inward Remittances Directive No. FXD /70/2021**

Six months after the issuance of Directive No FXD/66/2020, the National Bank of Ethiopia issued a new directive cited as ‘Retention and utilization of export earnings and inward remittance Directive No FXD/70/2021’ in March 2021. This directive diverges significantly from the two previous directives on several fronts. First, the directive merges accounts A and B into one account. Secondly, 30% of total export earnings are immediately surrendered to the National Bank. Of the remaining 70% of foreign currency earnings, exporters of goods and services as well as recipients of inward remittances have the right to retain 45% of their export earnings and remittances in foreign currency indefinitely. The remaining 55% of the 70% was required to be immediately surrendered to the respective bank at the prevailing exchange rate. Hence, exporters and recipients of inward remittance only had access to 31.5% of the total export earnings and inward remittance. Even though the directive significantly restricts the amount of foreign currency to be accessed, it frees retention account holders to utilize the foreign currency for any purposes, if they have the required business licenses to do so.

- **Retention and Utilization of Export Earnings and Inward Remittances Directive No. FXD /73/2021**

Again, six months after the issuance of Directive No FXD/70/2021, the National Bank issued the "Retention and Utilization of Export Earnings and Inward Remittances Directive No. FXD/73/2021. This directive had the effect of reducing the 31.5% right of exporters and recipients of inward remittances to access foreign currency credited to their retention account to 20% (40% of 50%). In addition to the 11.5% decrease in forex retention and utilization by exporters and recipients of inward remittances, the directive introduced forex transfers to non-governmental organizations to form part of the ambit of its regulation.

- **Retention and Utilization of Export Earnings and Inward Remittances Directive No. FXD/ 79/2022**

Directive FXD /73/2021 has lasted only four months, causing many grievances by exporters and recipients of inward remittances, mainly manufacturing exporters whose businesses are predominantly dependent on forex to import raw materials and other inputs. On January 6, 2022, the National Bank issued a new directive, FXD/79/2022, that obliges banks to surrender 70% of foreign currency earnings to the National Bank. The respective banks through which the foreign currency is brought were given the right to convert 10% of the foreign currency earning immediately upon deposit. With this arrangement, exporters and recipients of inward remittances have access to only 20% of foreign currency earnings and inward remittances. The directive does not have any restriction in the purposes of utilization of the retained foreign currency if the retention account holder has the required business license to do so.

- **Franco Valuta and suppliers credit**

Franco Valuta, in Ethiopia, refers to a license to import goods on which no foreign currency is payable from the banking system and is governed by Council of Ministers Regulation No. 88/2006 (ERCA 2006). The importation of goods on a franco valuta basis is restricted to use by (a) diplomatic missions and (b) businesses that are 100% foreign owned. The broader use of franco valuta may clash with ERCA tax requirements. Many of the businesses using franco valuta benefit from long corporate tax holidays as they export 100% of their production.

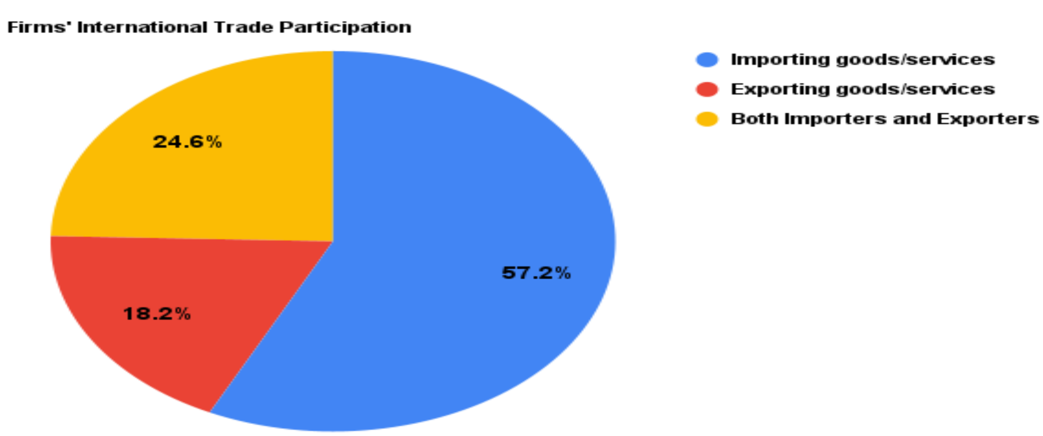
The supplier credit scheme allows importers to receive goods from suppliers on short-term credit terms provided the business is either a domestic business which is both an exporter and the loan is going to finance an exporter or a 100% foreign-owned entity with a debt-equity ratio of no more than 60:40, with clear loan repayment arrangements and purpose.

5. Survey Results

5.1. Firms' participation in international trade

In our sample, imports dominate the international activities of sampled firms, where 57% of firms participating in international trade are engaged only in imports (see Figure 5-1). Indeed, this is expected as it mirrors the trade composition of the Ethiopian economy. Like most developing economies, Ethiopia is predominantly import-dependent. Since 2013, imports have accounted for more than three-fourths of Ethiopia's total trade (NBE, 2022). On the other hand, exporting is limited to a small fraction of firms in our sample, only 18.2% of firms are engaged exclusively in exporting activities. About a quarter of firms in our sample are engaged in both imports and exports. 57.5% of the exporters are also engaged in importers as well. This is expected to be large as exporters prefer, given the overvalued exchange rate of the birr, to use their export proceeds to import other goods and/or use it to import inputs for their export productions. Or, given the difficulty of getting access to foreign exchange for imports, firms tend to engage in exports as well - as anecdotal evidence shows, they do this when in fact they are not making a profit in their export activities.

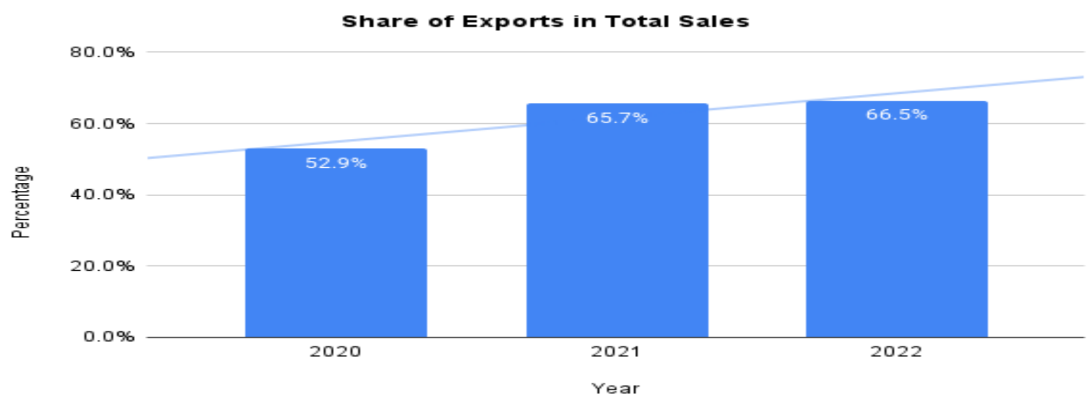
Figure 5-1: Firms' International Trade Participation



Source: Authors' own computation based on the firm-level survey data.

Furthermore, the share of exports in firms' total sales shows an increasing trend over the period 2020 to 2022. Firms in our sample, on average, export more than half of their outputs to the rest of the world. For firms in our sample, this increased from 52.9% in 2020 to 66.5% in 2022.

Figure 5-2: Shares of Export in total sales



Source: Authors' own computation based on the firm-level survey data.

5.1.1. Firms' participation in international trade: by size, ownership type and Sector

There are also significant differences in the degree of participation in international trade by firm size[13]. Our survey shows that the majority of large firms (50%) engage in both exporting and importing activities. On the other hand, while the majority of Micro enterprises (67.5%) of micro enterprises engage in importing activities only, 21.7 % engage in exporting activities only and 10.8% of them engage in both import and export business. This shows that larger firms are highly internationalized and active participants in the global value chain.

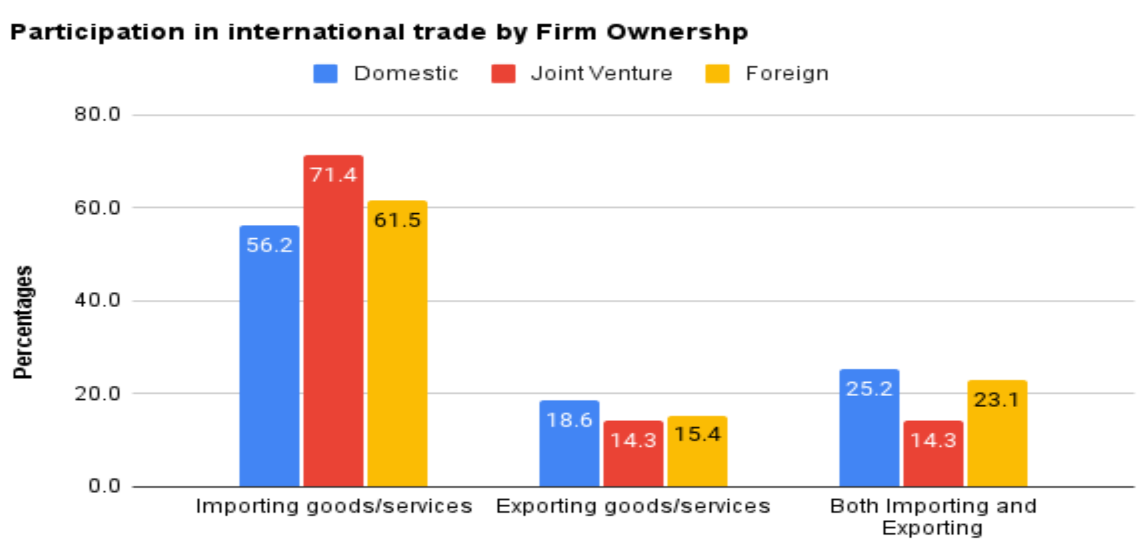
[13] Pearson chi2(6) = 23.9066, Pr = 0.001.

Figure 5-3: Participation in international Trade by firm size

Source: Authors' own computation based on the firm-level survey data.

In terms of ownership type, we see that domestic firms are relatively less likely to participate in imports only. While 71.4% of joint ventures and 61.5% of foreign firms engage in imports only, only 56.2% of the domestic firms engaged in imports only. About 71.4% of joint venture firms in our sample engage in importing activities only. Domestic firms are relatively more likely to participate in both imports and exports (see Figure 5-4). Although we expect joint ventures and foreign-owned firms to also get engaged in exporting, given their foreign networks and knowledge of external markets, their participation in exports appears to be a bit less than that of domestic firms and this might be due to their interest in the domestic market or due to domestic firms' strong preference to engage as a way of overcoming the foreign exchange shortage problem.

Figure 5-4: Participation in international trade by foreign and domestic firms

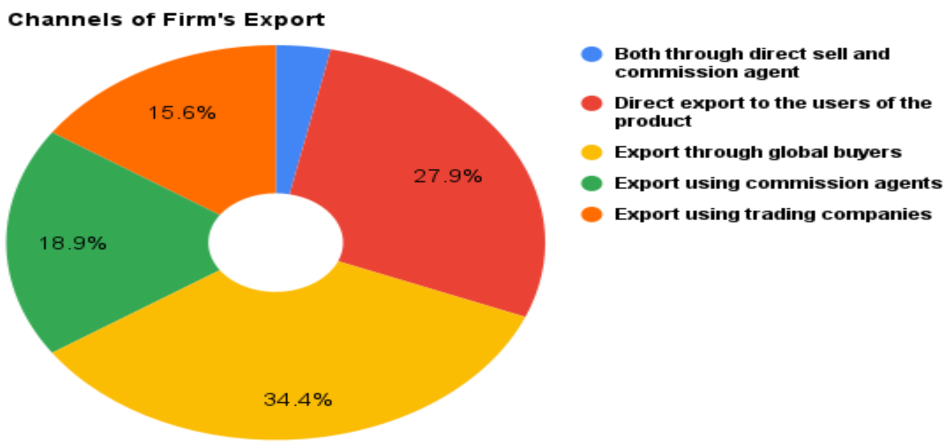


Source: Authors' own computation based on the firm-level survey data.

5.1.2. Modality of Exporting and Major Export Destination and Import Origin Countries

Firms were enquired about the channels through which they export their goods and services to the rest of the world. As shown in Figure 5-5, 28% of the exporting firms tend to export directly rather than by taking advantage of the services offered by other firms or middlemen. The results also offer an indication of the indirect involvement of considerable export businesses to GVCs through other firms or middlemen. Specifically, 34.4% of the firms report that they export goods and services through global buyers, whereas 18.9% of businesses engage in exports via commission agents and 15.6% of firms export using other trading companies.

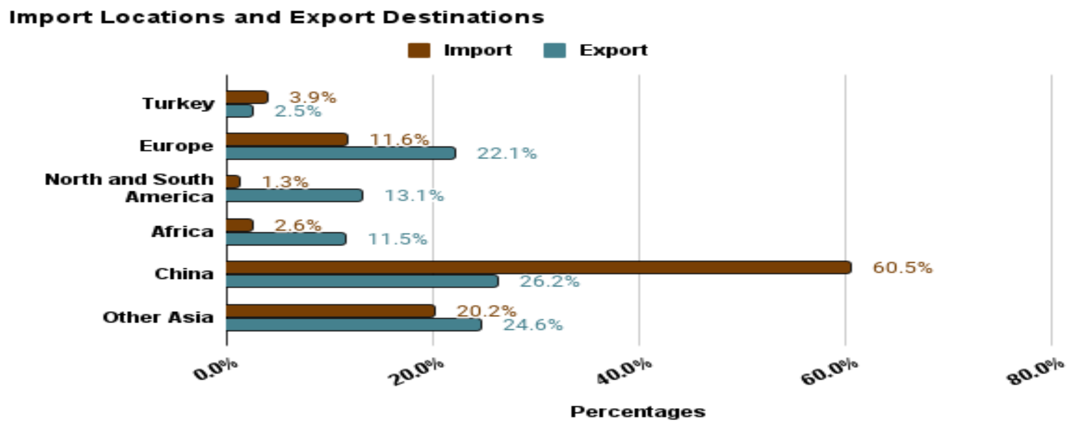
Figure 5-5: Modality of Exporting Goods and Services



Source: Authors' own computation based on the firm-level survey data.

In terms of the main destinations/origins of firms' exports/imports, a relatively larger number of firms indicate China as their main export destination (26.2%) and their source of imports (60.5%) in the last three years. While other Asian markets are the second largest, European markets appear to be the third largest import origins (22.1%) and export destinations (11.6%). Only about 11.5% and 2.6% of firms indicated African markets as their main export destination and import origins, respectively (see Figure 5-6). This highlights the importance of increasing intra-African free market access, particularly with recent initiatives to enhance regional integration through the African Continental Free Trade Area (AfCFTA).

Figure 5-6: Main Export Destination and Import Location of Firms in the last three years

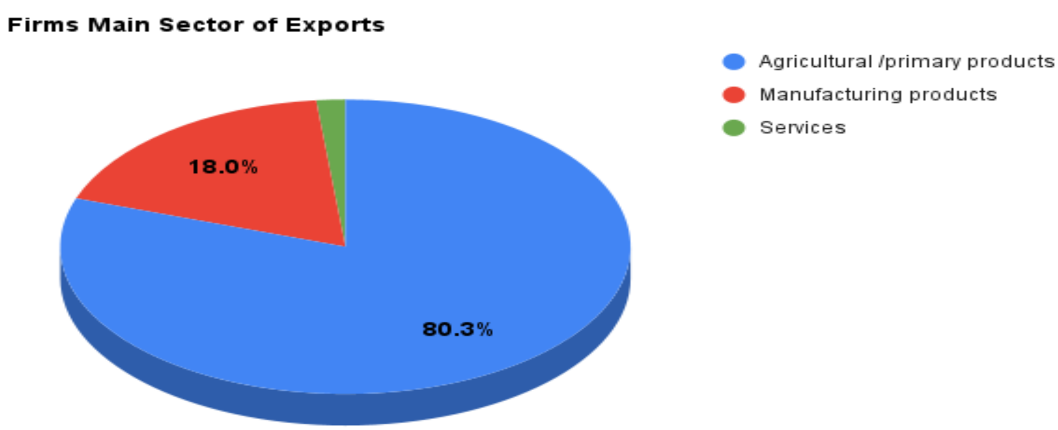


Source: Authors' own computation based on the firm-level survey data.

5.1.3. Share of Imports and Exports by Sector and Product Category

A large majority of the firms in our sample (80.3%) indicate that their exports mainly consist of agricultural/primary products, whereas 18% of the firms report that their exports are mainly of manufacturing products (see Figure 3.7). This is expected since Ethiopia's foreign exchange earnings are dominated by exports of agricultural/primary commodities.

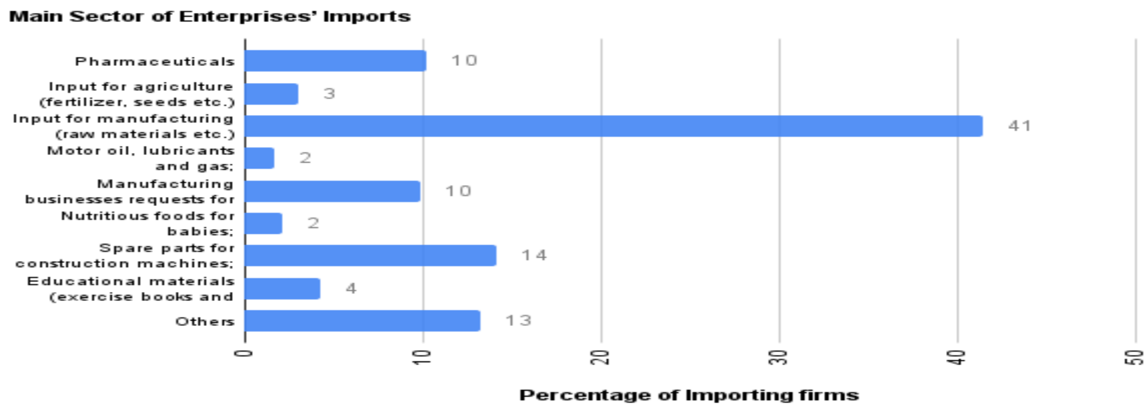
Figure 5-7: Exports by sector



Source: Authors' own computation based on the firm-level survey data.

Significantly, larger share of firms (41%) in our sample import inputs for manufacturing (raw materials and chemicals). This is followed by firms importing spare parts for construction machineries (14%) and pharmaceuticals (10%) etc (see Figure 5-8).

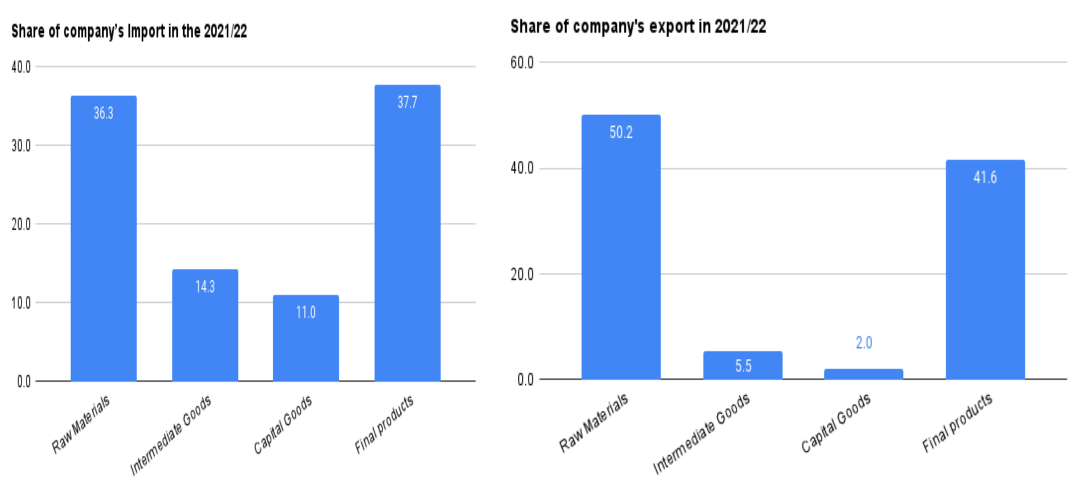
Figure 5-8: Major Sector of Enterprises' Imports



Source: Authors' own computation based on the firm-level survey data.

The shares of goods (i.e. raw materials, intermediate goods, final products or services) imported and exported by firms covered in our survey is presented in Figure 5-9. Overall, the sampled firms are more active in international trade for final products and raw materials. Raw materials, on average, constitute 36.3% and 50.2% of firms' imports and exports, respectively. On the other hand, final goods import and exports take up 37.7% and 41.6% of firms' total imports and exports, respectively. The shares of intermediate (14.3%) and capital goods imports (11%) in firms' total imports is as expected higher than the average export shares of intermediate goods (5.5%) and capital goods (2%) in firms' total exports.

Figure 5-9: Share of Imports and exports by product category

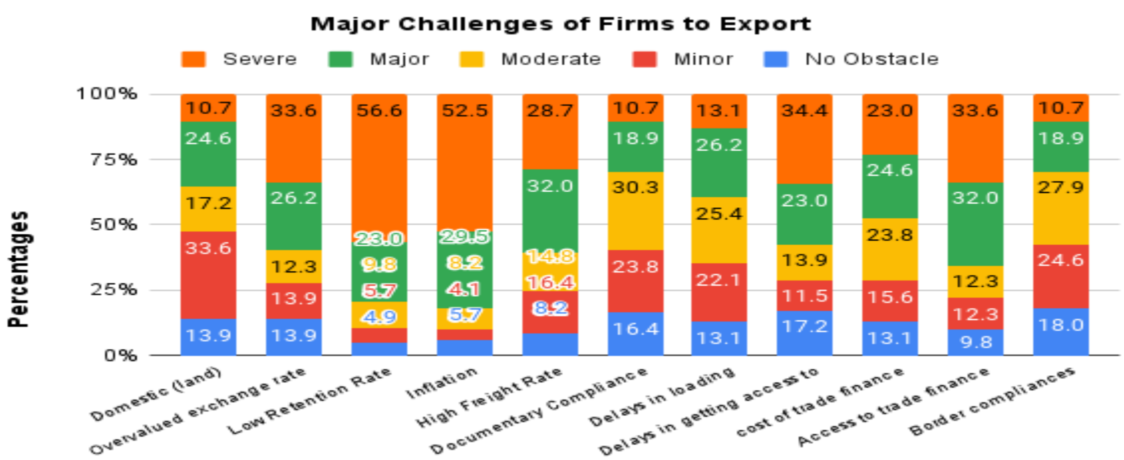


Source: Authors' own computation based on the firm-level survey data.

5.1.4. Challenges in Exporting and Importing

We have also asked firms to rank the potential challenges for their importing and exporting businesses with the aim of assessing how their ability to engage in international trade is affected by these factors. Since the challenges faced by firms when trading internationally differ between exports and imports, we gauge those barriers separately in both exporting and importing activities. Exporters were asked the main challenges of exporting and 56.6% of the exporters indicated that they are severely challenged by the low foreign exchange retention rate (inability to use their export proceeds) followed by inflation (52.5%), delays in getting access to trade finance (34.4%), access to trade finance (33.6%) and cost of trade finance (23%). In addition to these, firms indicated the overvalued exchange rate of the birr (36.6%) and high freight rate (28.7%) as the most sever obstacles for their exporting business (see Figure 5-10).

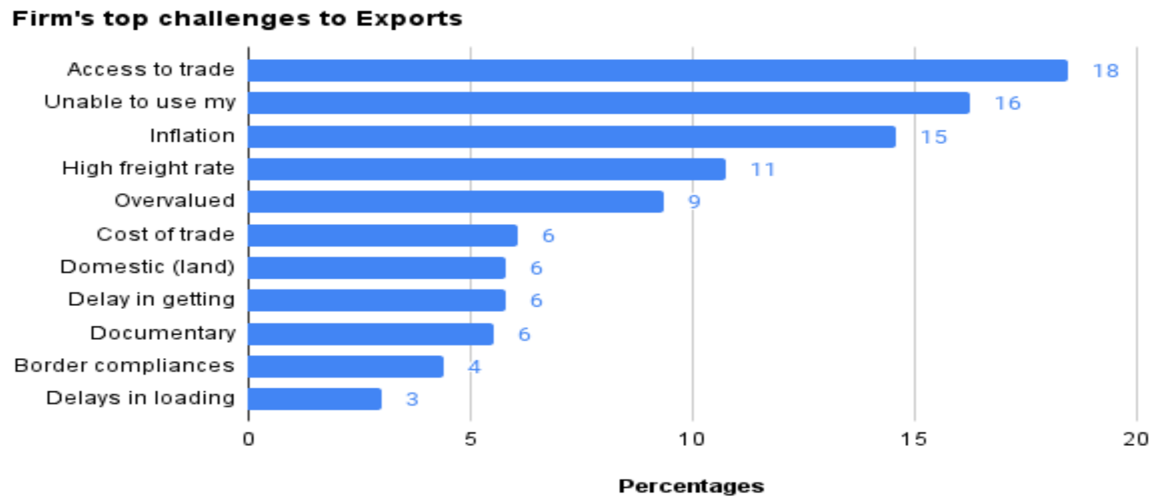
Figure 5-10: Major challenges of firms to export



Source: Authors' own computation based on the firm-level survey data.

We also enquired exporting firms to rank their top challenges for export activities. 18% of enterprises cite access to trade finance as their primary constraints followed by retention rate (16%) and inflation (15%) (Figure 5-11). This finding is consistent with the Global Enabling Trade Report of the World Economic Forum (WEF, 2016), lack of trade finance is among the top three exporting obstacles for half of the countries in the world including Ethiopia.

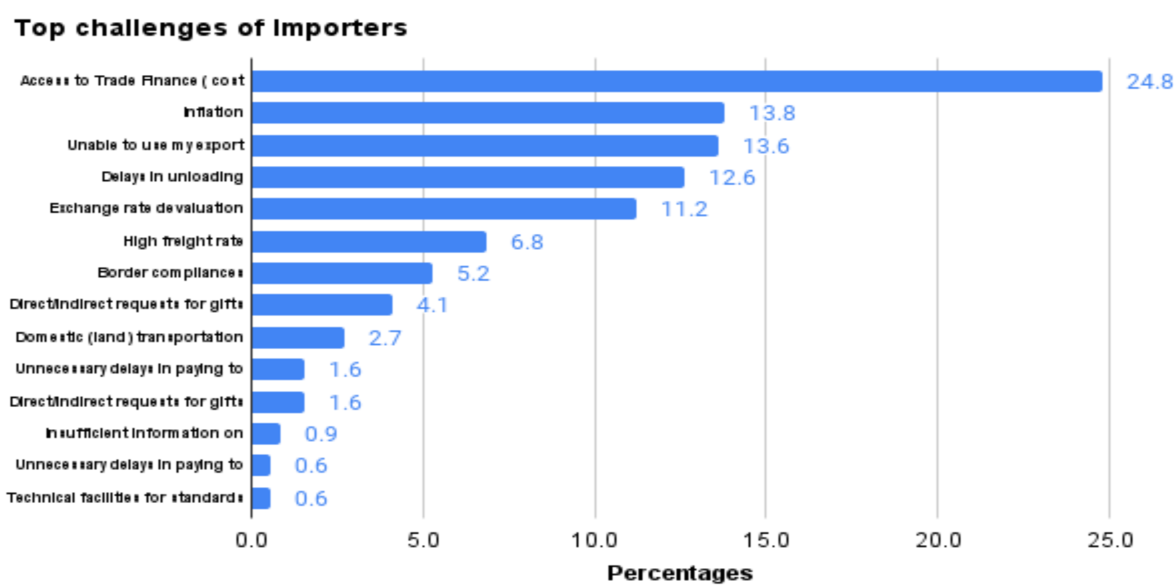
Figure 5-11: Firms' top constraint to Export



Source: Authors' own computation based on the firm-level survey data.

Similarly, about a quarter of firms in the import business cite access to trade finance (in terms of delays and cost of getting trade finance) as their primary constraint for their import activity.

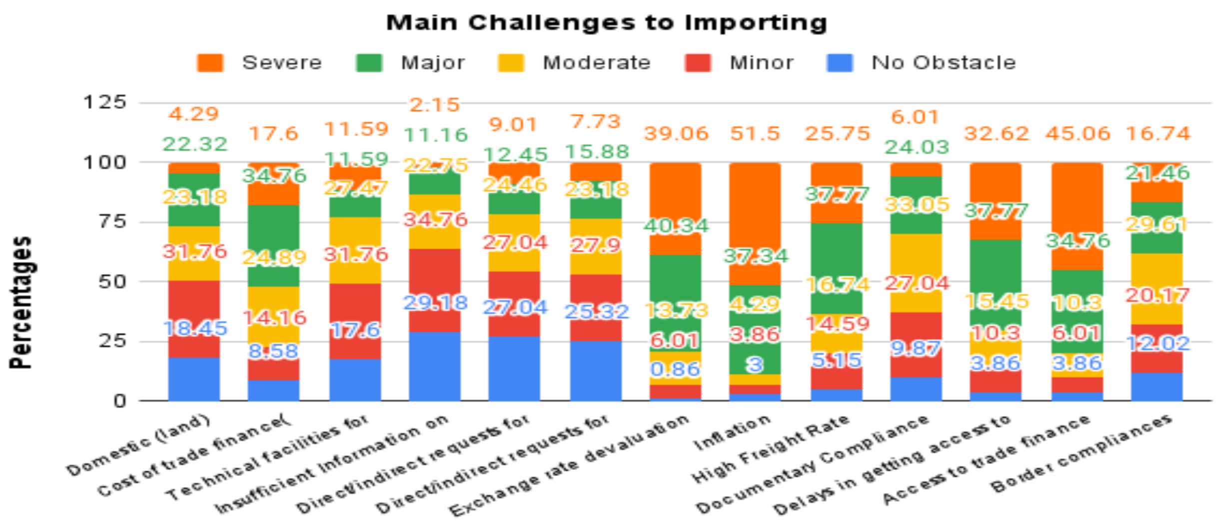
Figure 5-12: Firms' top challenges to Import



Source: Authors' own computation based on the firm-level survey data.

Moreover, we also asked importers about the major challenges they face while importing goods and services from the rest of the world. About 40.3% of the firms report that they are severely challenged by exchange rate devaluation, while 37.7% of them are severely challenged by high freight rates and delays in getting access to trade finance (see Figure 5-13).

Figure 5-13: Main Challenges to Importing



Source: Authors' own computation based on the firm-level survey data.

5.1.5. Average Number of days to Export and Import

Both importers and Exporters were asked the average number of days it takes to get customs clearance for imports and exports into and from Ethiopia.[14] Results from the surveyed firms indicate that the average number of days a particular firm requires to export is 35 days, while it takes importers an average of 44 days to claim their goods from customs (See Table 5-1). This is relatively higher than the world average of 7 days required to clear exports through customs, SSA countries' average of 11 days and low-income countries' average of 12 days, and needs a lot of work for improvement.[15]

[14] [*Q2.7 In your recent exports, how many days did it take on average from the time this establishment's goods arrived at their main point of exit (e.g., port, airport) until the time these goods cleared customs? ____________days] and [Q3.12 When this firm imported in its latest import, how many days did it take on average from the time these goods arrived at their point of entry (e.g. port, airport) until the time these goods could be claimed from customs? ---------------------number of days)].*

[15] The figures for other countries are obtained from World Development Indicators. The latest information on Ethiopia is only from 2015 and the number of days required to clear exports through customs was 8 days.

Table 5-1: Number of days to import and export

Variable	Obs	Average Number of Days	Std. Dev.	Min	Max
Export	122	35.5	29.7	1	120
Import	233	44.6	32.6	3	120

5.2. Firms' Demand for Trade Finance

We present evidence of firms' demand for trade finance from firm surveys. It is clearly observed that the demand for trade finance among firms in Ethiopia is high. The study revealed that most of the firms surveyed needed some form of trade finance to support their international trading activities (see Table 5-2 below). This includes firms that needed trade finance to enter export markets or to import intermediate inputs, capital goods or final products. Interestingly, only 55.4% of firms that needed trade finance applied for it; with a share of 44.6% making decisions not to do so (see Table 5-2). The 44.6% might indicate the proportion of firms that refrain from applying for trade finance discouraged by previous rejections on their application for trade finance.

Table 5-2: Firms that needed trade finance facilities in 2021/22

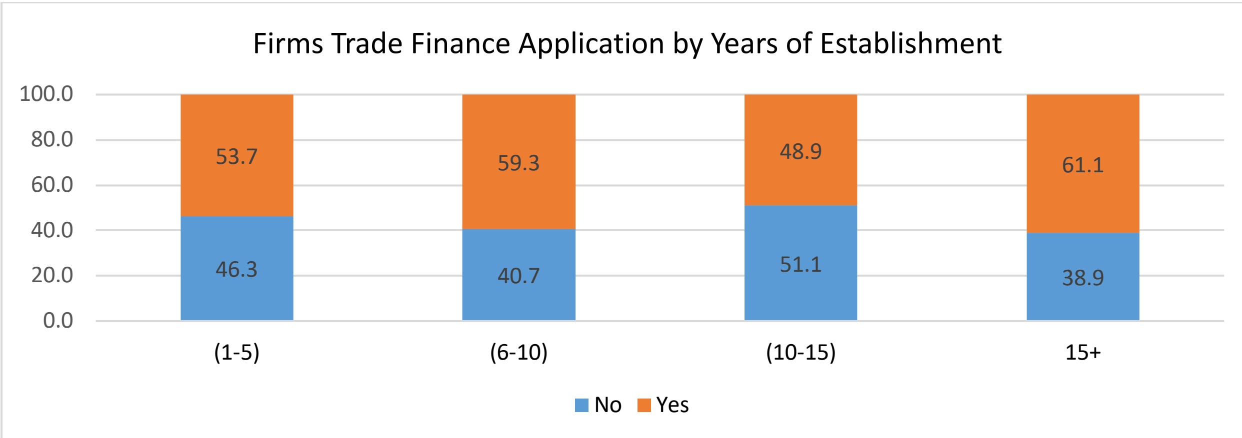
Did you apply for a trade finance loan last year (in 2021/22)?		
Applied for TF?	Number of Firms	Percent
No	127	44.6
Yes	158	55.4
Total	285	100

Source: Authors' own computation based on the firm-level survey data.

5.2.1. Trade Finance Applications by Age and Size of the Firm

The study also highlights the relationship between firms' likelihood of applying for trade finance in 2021/22 and enterprise size. Empirical evidence shows that firms that don't want to apply tend to be smaller and younger firms (Mac and Bhaird, Sanchez Vidal, & Lucey, 2016). In this regard, our study also shows that relatively fewer number of older and more experienced firms (38.9% of the above 15 years of establishment firms) are the least discouraged firms to apply for trade finance (Figure 5-14). Again, we also find evidence that 60.2% of small firms and 41.4% of medium-sized enterprises that needed trade finance chose not to apply for one. For large firms with 100 or more employees, only 36.7% decided not to apply for trade finance even though they had a legitimate need for one (see Figure 5-14). This is perhaps an indication of the degree of missed opportunity in trade participation for SMEs due to the discouragement that arises from fear of being rejected in their trade finance applications.

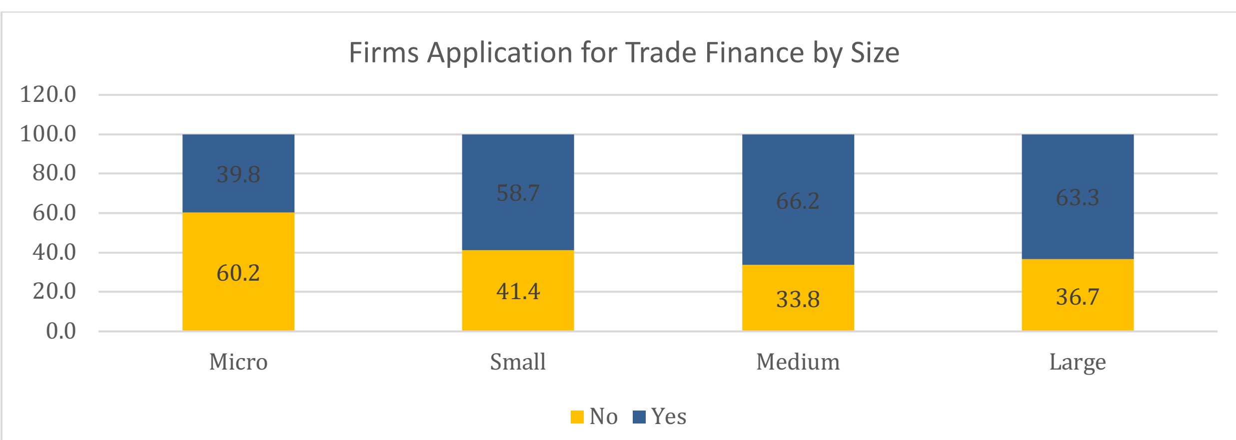
Figure 5-14: Firms' years of establishment and decision to apply for trade finance



Source: Authors' own computation based on the firm-level survey data.

Studies also show that smaller traders are less likely to apply for trade finance discouraged by previous rejections from banks (WTO, 2019) and banks seem to prefer lending to larger firms that are considered less risky. Apart from being perceived riskier, smaller firms are less likely to fulfill the stringent requirements for getting trade finance from banks. Consistent with this, our survey also shows that 60.2% and 41.4% of micro and small enterprises, respectively, don't apply for trade finance. While on the other hand, only 33.8% of Medium and 36.7% of Large firms decide not to apply for trade finance (see Figure 5-15).

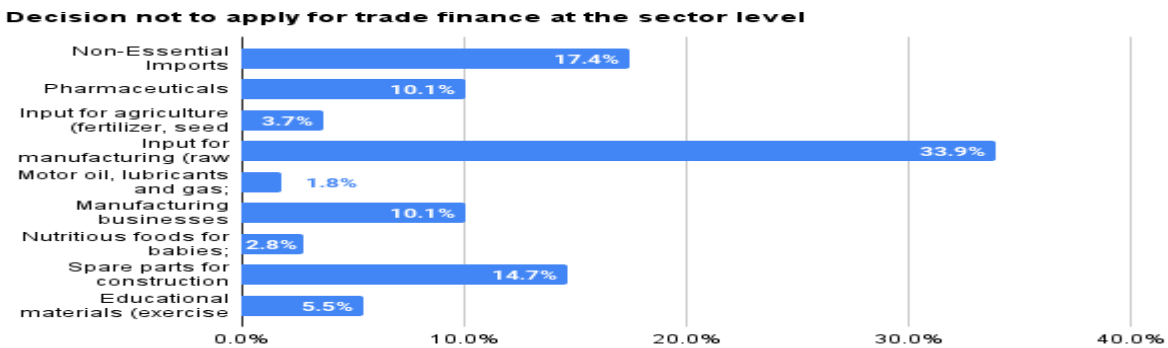
Figure 5-15: Decision to apply for trade finance by firm size



Source: Authors' own computation based on the firm-level survey data.

When also we look at sectoral variations in firms' decision not to apply for trade finance. Firms operating in the importing of inputs for manufacturing (33.9%) are the most likely to be discouraged for trade finance applications. Almost more than a quarter of such firms fail to apply for trade finance. And about 17.4% of firms operating in the non-essential sector chose not to apply for trade finance even when needed (see Figure 5-16).

Figure 5-16: Importing firm's decision not to apply for trade finance



Source: Authors' own computation based on the firm-level survey data.

5.2.2. Ease of getting trade finance

Access to trade finance remains a significant challenge for enterprises engaged in international trade, especially for SMEs. While international trade is considered an important activity for the majority of the firms surveyed, more than half of the firms consider getting access to trade finance for importing and exporting as difficult. Specifically, while about 73% of the Exporting firms reported that getting access to trade finance is difficult or very difficult, 82% of importing firms indicated that it is difficult or very difficult to get access to trade finance. Only very few of the firms' started getting access to trade finance for export and import is easy (see Table 5-3). Only 3.86% of importing and 6.56% of exporting firms regard getting access to trade finance to be easy or very easy.

Table 5-3: Ease of getting access to trade finance

	Importers		**Exporters**	
	No. of Firms	Percent	No. of Firms	Percent
Very difficult	133	57.08	50	40.98
Difficult	58	24.89	39	31.97
Fair (Neither difficult nor easy)	33	14.16	25	20.49
Easy	7	3	7	5.74
Very Easy	2	0.86	1	0.82
Total	**233**	**100**	**122**	**100**

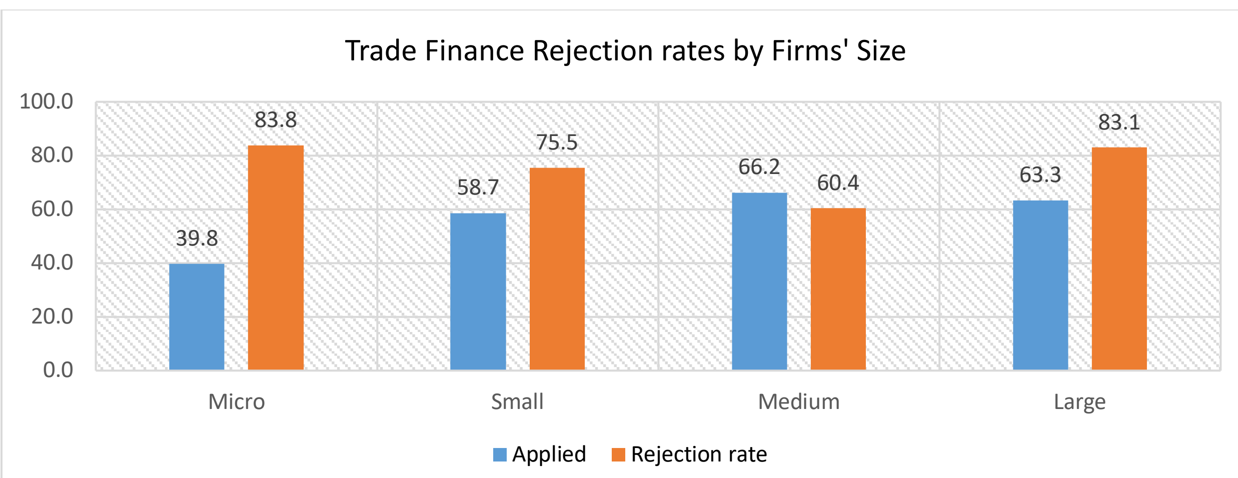
Source: Authors' own computation based on the firm-level survey data.

5.3. Trade Finance Application Rejections

Trade finance application rejections also indicated the unmet demand for trade finance. When firms face rejections on their trade finance applications, they would normally resort to less optimal solutions such as drawing on their own funds, borrowing through informal channels, from their suppliers, or from microfinance institutions (WTO and IFC, 2022). SMEs are disproportionately affected by trade finance applications. Globally, while over half of trade finance requests by SMEs are rejected, the rate of rejection for multinational companies is only 7% (WTO,2019). Our survey of commercial banks in Ethiopia shows that the rate of rejection for trade finance is high. Commercial banks in Ethiopia, on average, reject close to 56% of trade finance applications by firms.

Overall, in our sample 44.6 % of firms indicate that their trade finance applications were rejected. When we disaggregate this by firm size, we see that the rejection rate is higher for Micro and Small enterprises as suggested by the literature. Specifically, out of the total micro-enterprises that applied for trade finance (38.9%), the overwhelming majority 83% indicated that their application was rejected. Similarly, out of the total small-enterprises that applied for trade finance (58.7%), 75.5% indicated that their application was rejected. On the other hand, the rejection rate for Medium and Large firms appears to be 60.4% and 83.1%, respectively (See Figure 5-17).

Figure 5-17: Rate of Rejections in Trade Finance Applications by Firm Size

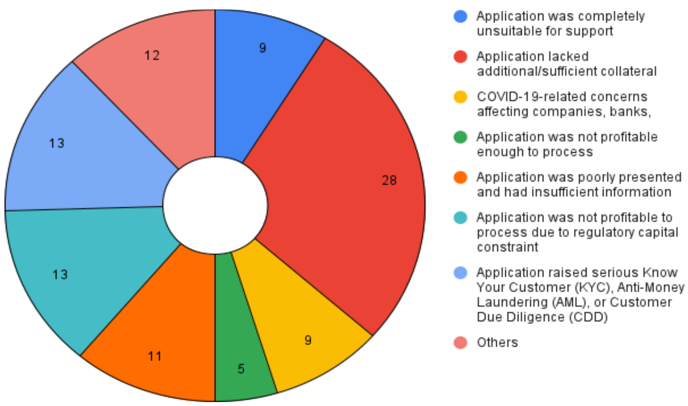


Source: Authors' own computation based on the firm-level survey data.

5.3.1. Reasons for rejection of trade finance: Evidence from Demand and Supply

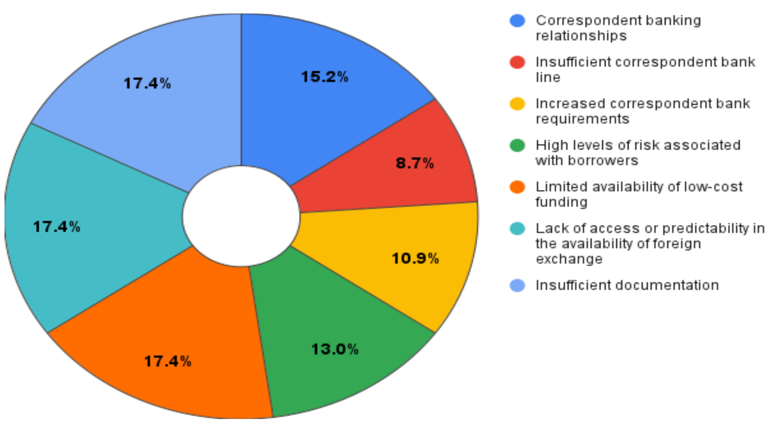
Understanding the rationales for banks' rejection of trade finance applications from the perspective of firms is essential if policymakers are to address both demand and supply-side challenges to shore up trade finance for enterprises, particularly for SMEs. Accordingly, we assess the main reasons for rejection of trade finance applications by firms in Ethiopia. Insufficient collateral is cited by 28% of firms as the main reason for rejection of their trade finance application, followed by constraints on banks' capital (13%) (see Figure 5-18). On a similar vein, banks also cite insufficient documentation (17.4%) and client creditworthiness (13%) as the main reasons for banks' rejection of trade finance applications made by firms (Figure 5-19).

Figure 5-18: Reasons cited by firms in for trade finance application rejections



Source: Authors' own computation based on the firm-level survey data.

Figure 5-19: Reasons cited by banks for rejecting trade finance applications

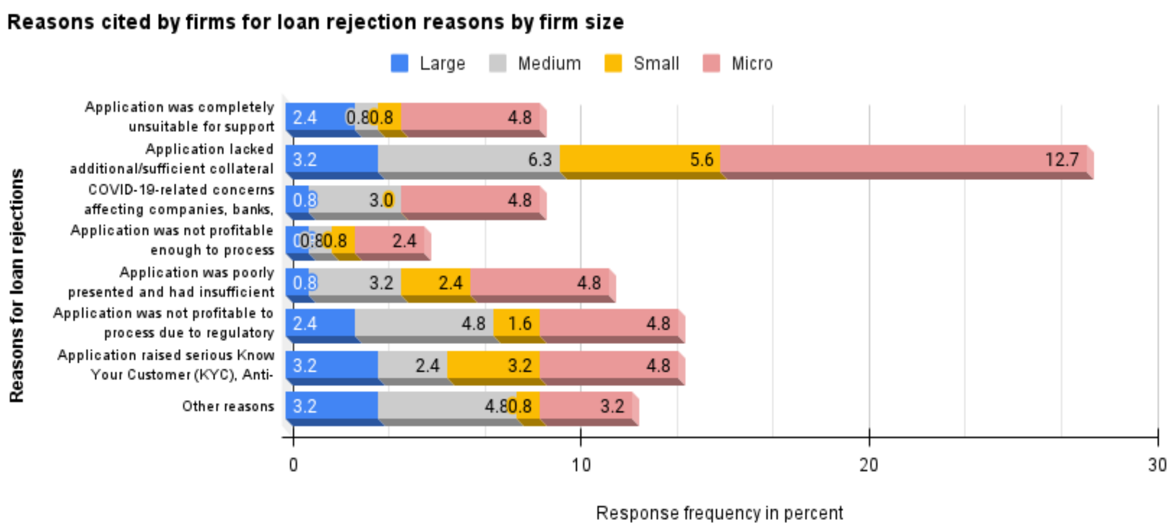


Source: Authors' own computation based on the firm-level survey data.

5.3.2. Reasons cited by for trade finance loan rejections: by firm size

In general terms, SMEs face challenges in fulfilling the requirements of collateral, burdensome loan documentation process. 12.7% of micro enterprise firms cite insufficient collateral requirements as a reason for being rejected for trade finance applications.

Figure 5-20: Reasons for Loan rejection by firm size



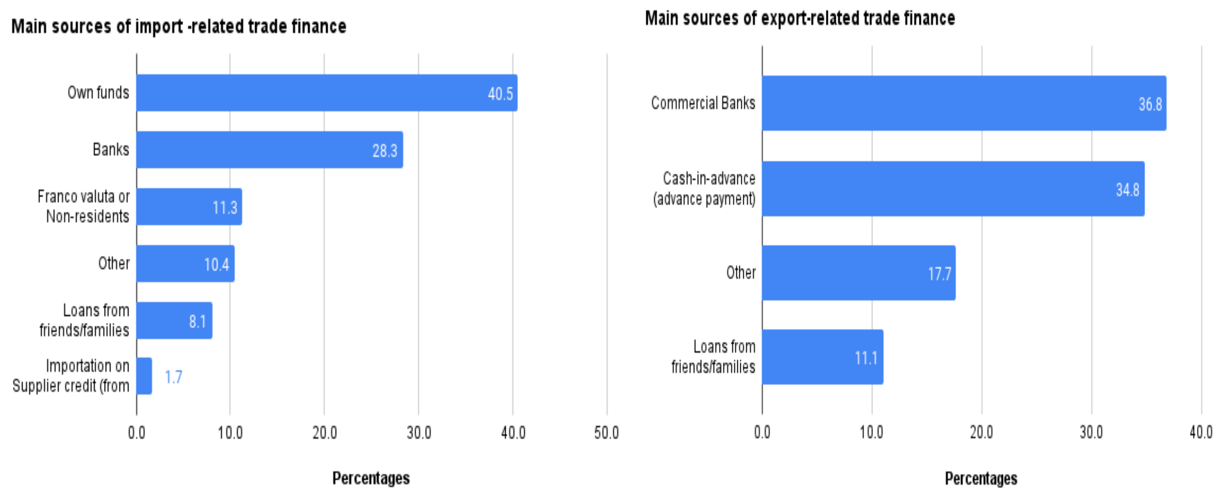
Source: Authors' own computation based on the firm-level survey data.

5.4. Main Sources of Import and Export-related trade finance in Ethiopia

Existing literatures and results from other surveys indicated that only 20-40% of rejections turn into foregone trade[16]. Rejected trade finance applications may lead firms to look for alternative financing options such as drawing on their own funds, borrowing through informal channels, from their suppliers, or from microfinance institutions (WTO and IFC, 2022). In our survey, more than 40% of importers responded they use their own export proceeds for carrying out international trade. Again, more than one-third of exporters use cash-in-advance to engage in international trade.

[16] African Development Bank (2022)

Figure 5-21: Main sources of import and export-related trade finance

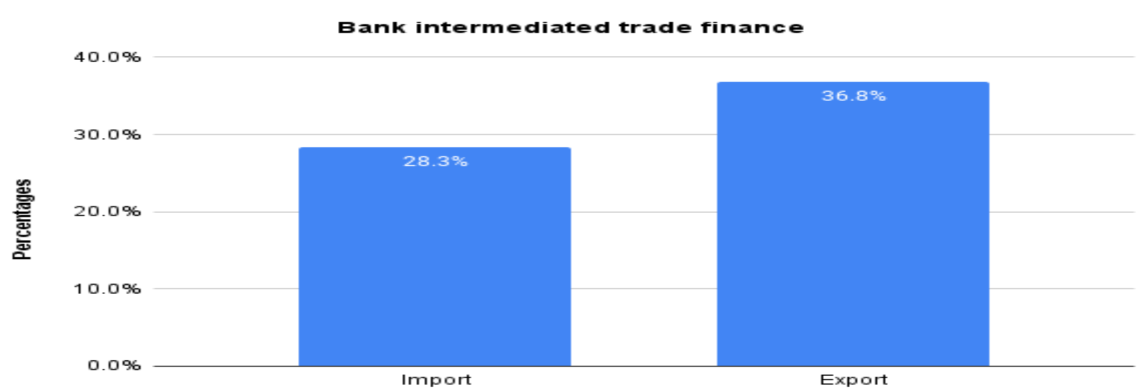


Source: Authors' own computation based on the firm-level survey data.

5.4.1. Bank intermediated trade finance

On average, over the period 2011-19, only 40% of Africa's total international trade is intermediated by Banks while 80% of world trade is bank intermediated (AfDB and AFREXIMBANK, 2020). Figure below presents evidence on the bank-intermediated trade finance for the import and export trade in our survey. According to our survey data, on average, 28% of imports and 37% of exports in Ethiopia relies on the bank-intermediated trade finance and this is lower than the Africa (40%) and world (80%) average (Nyantakyi, E. B. (2023)[17].

Figure 5-22: Bank-intermediated trade finance



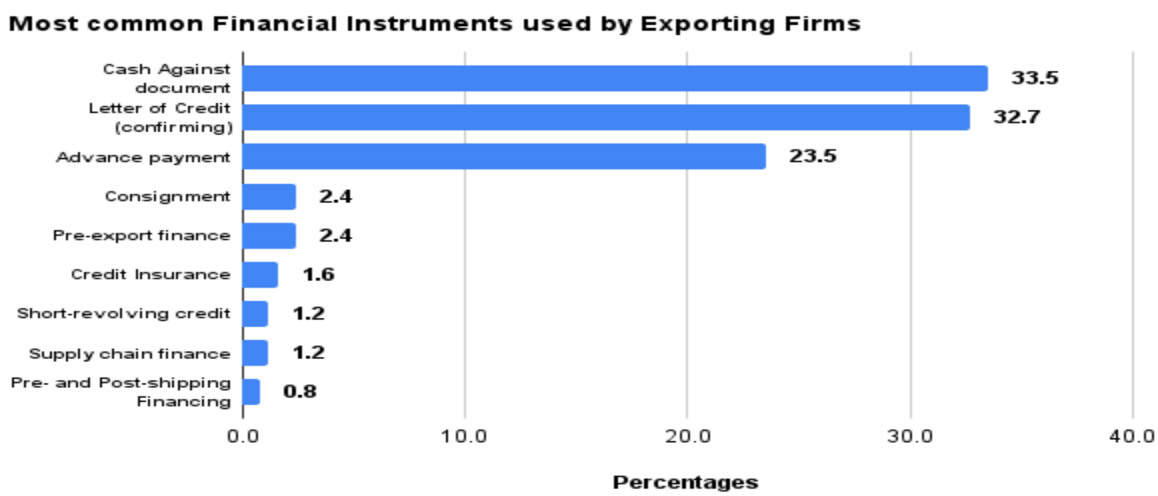
Source: Authors' own computation based on the firm-level survey data.

[17] Nyantakyi, E. B. (2023). Bank-intermediated trade finance and the intensive margin of African trade. *The World Economy*, *46*(4), 1144-1160.

5.5. Trade Finance Instruments Used by Firms

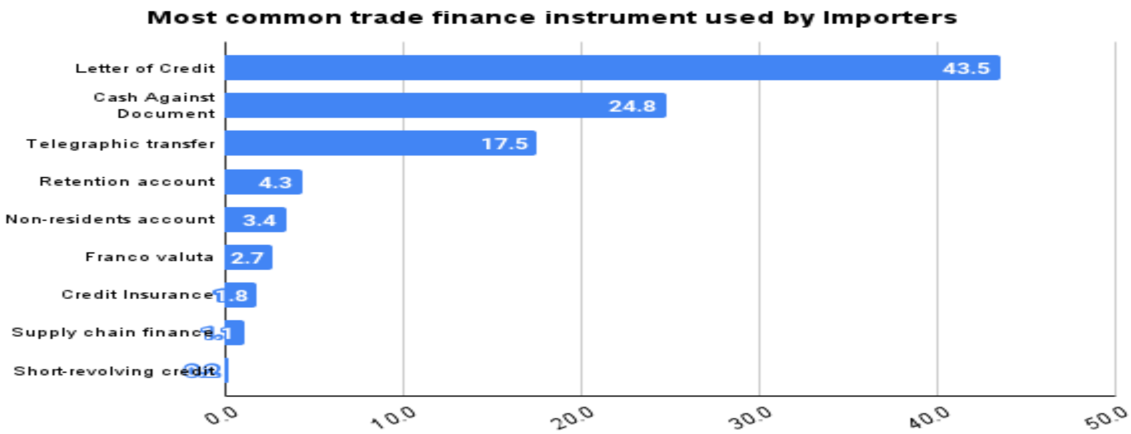
Given their internationally accepted status, LCs have been most widely used instruments, although there has been an increasing shift towards less traditional trade finance solutions like open account trade terms. This is mainly attributable to the reduced risk appetite for African bank obligations. Our results show that firms in Ethiopia rely more on unfunded trade finance instruments. Specifically, the survey results show that 33% of exporters and 42% of firms in the importing business rely on letters of credit (see Figure 5-23 and Figure 5-24). This is relatively higher than the African average reported in ADB (2022), where only 6.3% of exporters and 15% of importers rely on letters of credit for trade finance in Africa. For instance, in Kenya (44%) and Tanzania (32%) short-term revolving credit and pre-export finance are the most common forms of trade finance used by exporters and importers (ibid).

Figure 5-23: Most common trade finance instrument used by exporters



Source: Authors' own computation based on the firm-level survey data.

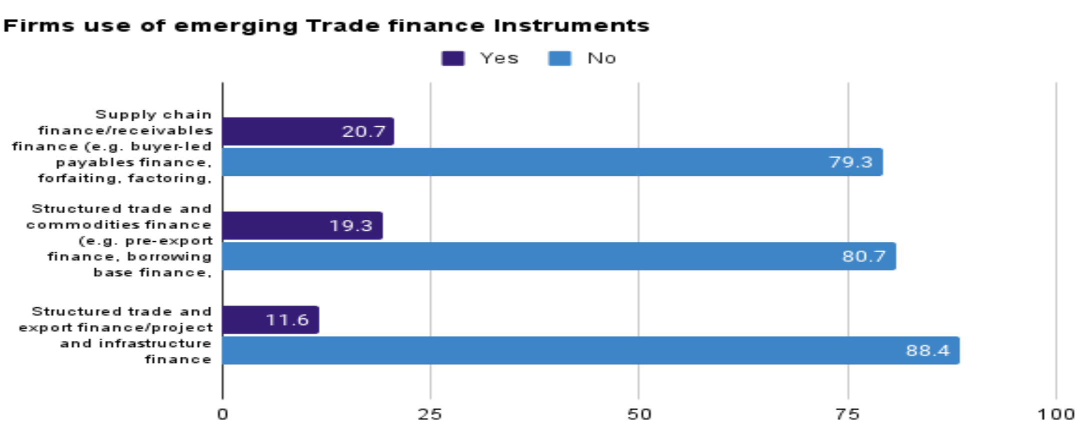
Figure 5-24: Most common trade finance instrument used by importers



Source: Authors' own computation based on the firm-level survey data.

Given that there is a long period between the time the goods for export are produced (costs of production are incurred) and the time of receiving export proceeds, pre-export finance or funded trade finance instruments that provide working capital or finance the production of goods for export is very important. However, as shown in Figure 5-25 below, very few firms use emerging solutions to trade finance in Ethiopia. More than three-fourths of firms participating in international trade in Ethiopia indicated that they are not using buyer-led payables finance like forfeiting, factoring, or structured commodity trade finance.

Figure 5-25: Use of emerging trade finance/ supply chain finance

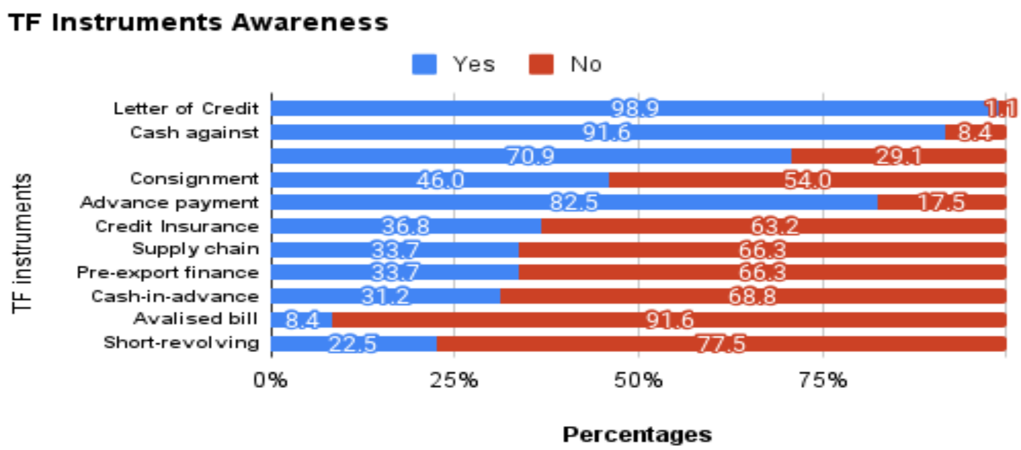


Source: Authors' own computation based on the firm-level survey data.

5.5.1. Awareness of Trade Finance Instruments by firms

We also offer some highlights to understand firms' awareness of both traditional (unfunded) trade finance and emerging trade finance solutions. Almost all firms are aware of the traditional financial instruments while there is a limited awareness of available emerging trade financing options. This is mainly due to limited availability and knowledge of alternative trade finance instruments tailored to the Ethiopian financial market.

Figure 5-26: Awareness of trade finance instruments by firm size



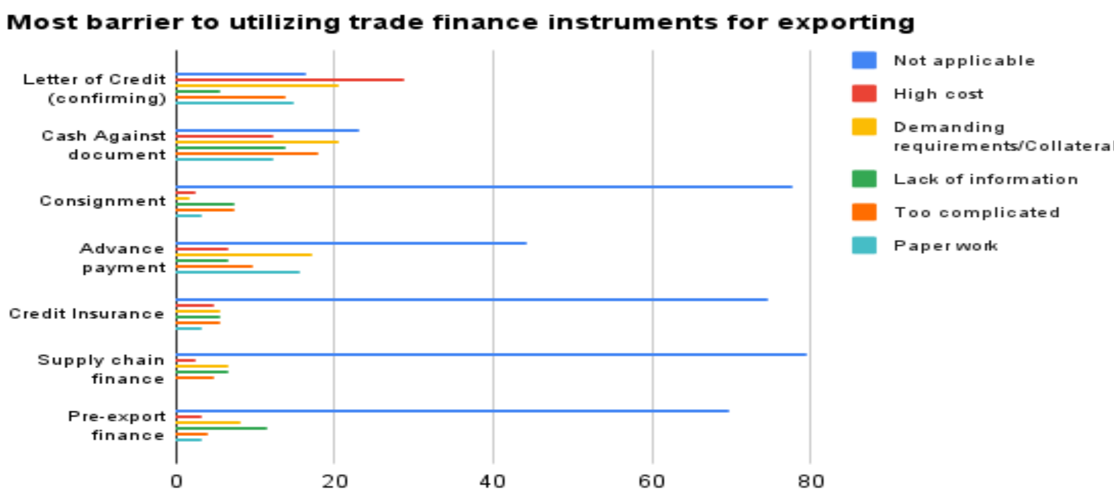
Source: Authors' own computation based on the firm-level survey data.

5.5.2. Challenges in Usage of and Access to Trade Finance Instruments

In order to provide insight to the challenges of firms in using trade finance instruments, we asked firms for the instruments they use and do not use, what is the biggest barrier to utilizing those trade finance instruments for exporting. The majority of firms responded that high cost/commissioning fees and demanding requirements like collateral are the main barriers to using most trade finance instruments for export. Moreover, 45% of importing firms reported high cost/ commission fees and 19% of them reported that demanding collateral requirements was the biggest barrier to utilizing letters of credit. Whereas, lack of information, demanding requirements and being too complicated are the main challenges for using pre-export and supply chain finance as well as advance payments (see Figure 5-27). Similarly, importing firms indicated that the letter of credit as a financing instrument has challenges due to its high cost, demanding (collateral) requirements and being too complicated (see Table 5-4).

In the case of both importing and exporting, the high cost of LC is indicated as a major challenge. The fee that Ethiopian commercial banks charge, averaged 7.76%of the transaction value (see Table 6-2), is higher than what banks in other countries charge. For example, while the average charge for LC in emerging markets is 2% of the transaction value, the average charges in Ghana (2.3%), Nigeria (3.5%), and Senegal and Côte d'Ivoire (4%) are lot lower compared to the rate Ethiopian banks charge (AfDB and AFREXIMBANK, 2020). Although the rate in Ethiopia is expected to be a bit higher, given the level of risk in the business and shortage of foreign currency in the economy, the observed difference is a bit exaggerated.

Figure 5-27: Most barriers to utilizing those trade finance instruments for exporting



Source: Authors' own computation based on the firm-level survey data.

Table 5-4: Most barrier to utilizing Letter of Credit for Importing

Letter of Credit	Number of Importers	Percent
Not applicable	20	8.58
High cost	105	45.06
Demanding requirements/Collateral	44	18.88
Lack of information	10	4.29
Too complicated	33	14.16
Paper work	21	9.01
Total	**233**	**100**

Source: Authors' own computation based on the firm-level survey data.

5.6. Factors contributing long cargo dwell time at seaports and dry ports: Firms perceptions

Though there is considerable effort by the Ethiopian government's, one of the initiatives include the logistics reform in the Homegrown economic agenda, to improve the efficiency of the logistics sector, the expected changes in the sector have not materialized yet. The Ethiopian National Logistics Strategy (ENLS) considers creating a reliable trade and finance system as one of its objectives in reducing the logistics cost and time and transforming the logistics sector. According to the ENLS document, 2019, it takes on average four months to import cargo into Ethiopia under the current logistics system, while the average global standard is one month. In terms of containerized general cargo, port dwell time at the port of Djibouti is

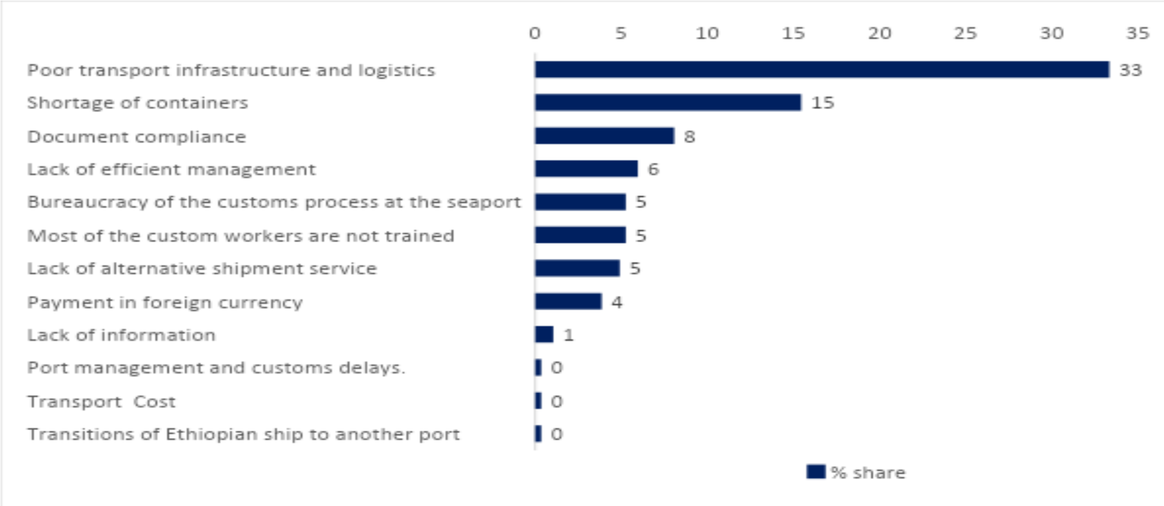
37 days and 59 days at Markov Decision Process (MDP), Ethiopia. Regarding port dwell time, the cargo dwell time is 10 times higher than the average global standard of 3 days. Ethiopia experienced high port dwell time for import cargo which is highly linked to importers' financial shortage. Different financial instruments are required to settle payments for banks, customs, ports and other logistics service providers and clear shipments from ports.

We have made an effort to identify the major factors that contribute to long cargo dwell time at seaports. According to the importers covered in our survey, poor transport infrastructure, shortage of containers, mismanagement in vessel schedules, and document compliance as the major factors contributing to long dwell time at ports. Firms mentioned that container fee and truck turnaround time, customs clearance, lack of loading machineries, limited storage capacity all have a direct impact on cargo dwelling time. There is also a problem of lack of information on whether the cargo arrived at dry port, lack of information and public notice on the relevant rules and regulations were also cited by the firms as a main reason contributing to long dwell time at port. The short vessel shipment schedule which is usually two days per week is also considered as the main reason for long dwell time at ports.

High Container fees resulting in higher demands for foreign currency can be taken as the major logistic challenges facing firms engaged in international trade. Delay in the process of customs clearance at Djibouti port is indicated as a major problem by some firms, the inspection of goods is time-consuming and causes significant delays. A number of firms mentioned the monopoly of the Ethiopian Shipping Lines, which has limited shipping capacity, and the mandatory rule of using its services creates significant challenges to the firms. not to look for alternative means of sea transport. Firms also stated that there are challenges in relation to delays in bank transfer of trade finance that indirectly contributes to the long dwell time.

Firms echoed the bureaucracy at customs, in relation to inspections and document processing, and lack of coordination among stakeholders consumes a significant amount of time and creates a major challenge. Firms also complained about Container Shortage and Vessel unavailability from Ethiopia shipping lines as well as the reluctance of the transitors for not speeding up the document processing at seaport.

Figure 5-28: Factors contributing to the long cargo dwell time at seaports



Source: Authors' own computation based on the firm-level survey data.

5.6.1. Factors that contribute to the high logistics costs and delays in Dry Ports: Importers' perception

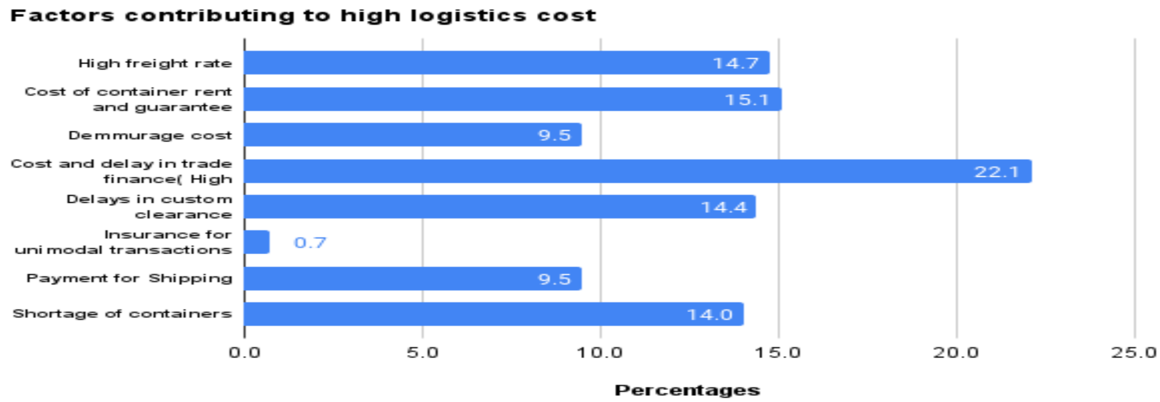
The larger a container or cargo stays at a port terminal, the higher the cost that a customer will have to pay. This can be passed on to customers in terms of higher freight charges and charges for longer cargo dwelling time, thus reducing the attractiveness for them to hub at a dry port. The other set includes direct charges, cargo dwell time, and minimization of dwell time in inland transport and reliability (Tongzon and Ganesalingam (2009).

Firms using dry port facilities stated that shortage of crane machines and lack of cargo handling equipment as the main problems at dry ports that causes long dwell time. They also stressed that dray port staff focusing more on bulk shipments rather than small shipments is one of the reasons for delays in dry ports. Bulky shipments can take more time in a dry port and poor infrastructure can contribute to long dwell time. Firms also indicated the high transportation cost and lack of adequate space as the main factors that contribute to the long dwell time and high logistics costs at dry ports. The lengthy paper work and inspection processes also cause significant delays in cargo dwell time at dry Port.

5.6.2. Factors contributing high logistics costs

22.1% of firms reported that cost and delays in trade finance is one the major factors contributing to high logistics cost in Ethiopia. The next most important factors that plays a role in raising logistic cost is the cost of container rent and guarantee (15.1%) and high freight rates (14.7%) (see Figure 5-29).

Figure 5-29: Factors contributing to High Logistics cost



Source: Authors' own computation based on the firm-level survey data.

6. Results from Bank Survey: Evidence from the supply side

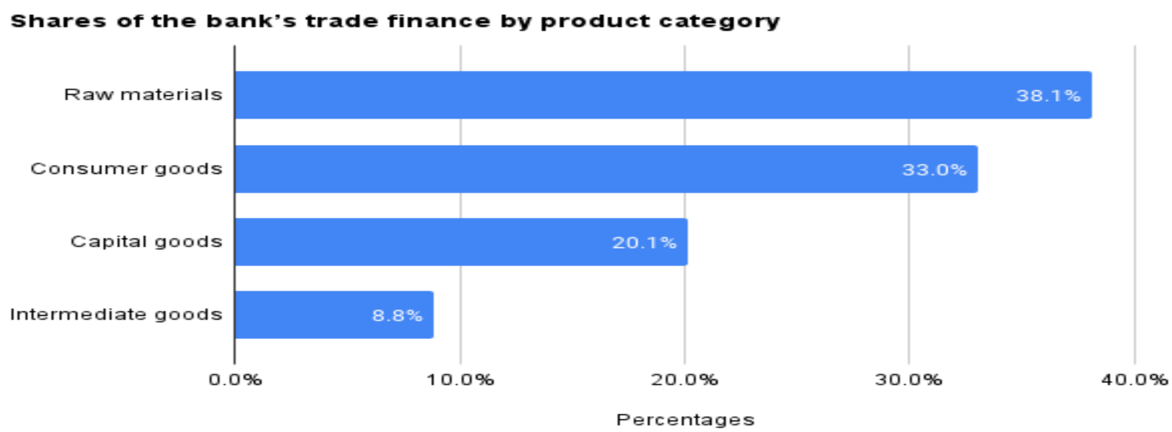
The growth of international trade has offered a considerable stimulus to the import and export financing roles of banks, specifically as an intermediary between importers and exporters. It would not have been easy to undertake trade across borders without the involvement of banks to expedite payments and receipts between the importers and exporters-notwithstanding the marked differences in national currencies. Bartoli et al. (2014) argue that bank support can be a crucial ingredient for favoring firms' internationalization. The banking system offers a wide range of instruments for payments for goods and services traded internationally, financing the delivery of goods and guaranteeing payment obligations by designed to meet the differing needs of buyers and sellers. In international trade transactions, there is typically a lag between the time at which the good or service is provided and the time at which payment is settled, necessitating the extension of credit by one party to the other. Global and local banks enable international trade by offering access to trade finance. A broad range of financial instruments through the banking system helps importers and exporters manage international payment risks and access working capital financing that is directly tied to their international trade transactions (John J. C., 2014).

Thus, we surveyed commercial banks in Ethiopia including government owned commercial and development banks on the state of trade finance facilities. The survey was conducted on 18 commercial banks in Ethiopia, representing almost all banking sectors that provide trade finance in the country. Banks were enquired how much trade finance they support and in what sectors, seeking to identify the barriers in providing access to trade finance.

6.1. Trade finance by product category

Improved access to trade finance for international trade participation can help boost trade, making it easier to import and export goods and services that would foster economic growth. The surveyed banks, on average, supplied 38.1% and 33% of their trade finance services for trade in raw materials and consumer goods, respectively. Only 20.1% and 8.8% of their trade finance services covers trade in capital goods and trade in intermediate goods, respectively. This is a reflection of Ethiopia's trade composition and contrasts with the ADB (2022) study, which shows that trade in capital and intermediate goods requires more support from letters of credit than consumer goods or raw materials.

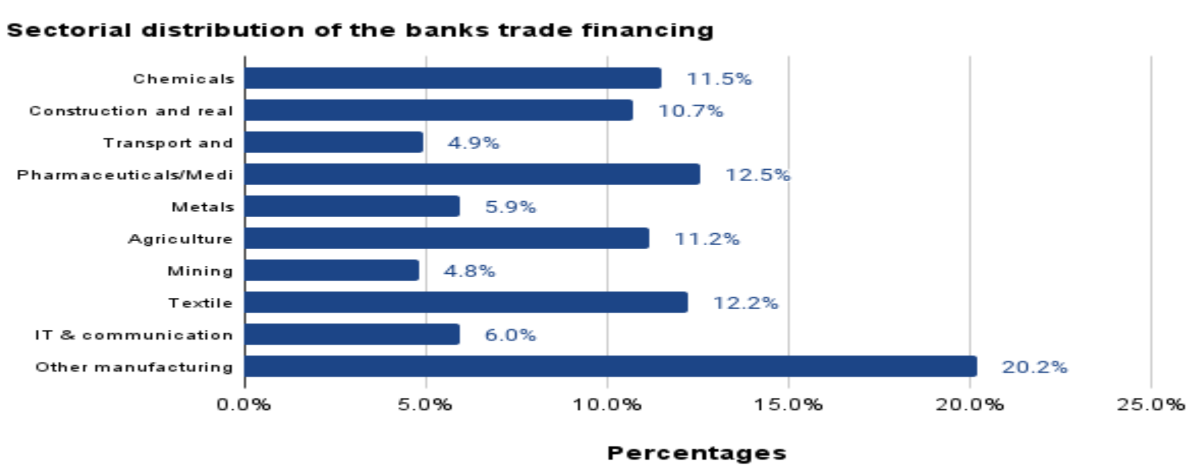
Figure 6-1: Share of bank's trade finance by product category



Source: Authors' own computation based on the Bank-level survey data.

We also found that banks covered in our survey allocated 20.2% of their trade finances for sectors such as other manufacturing and 12.5% for pharmaceuticals/medicals, and 12.2% for the textile sector. Meanwhile, sectors such mining, transport, metals and IT and communication are identified as sectors that received less than 10% of banks' trade financing (see Figure 6-2).

Figure 6-2: Sectoral distribution of the bank's trade financing

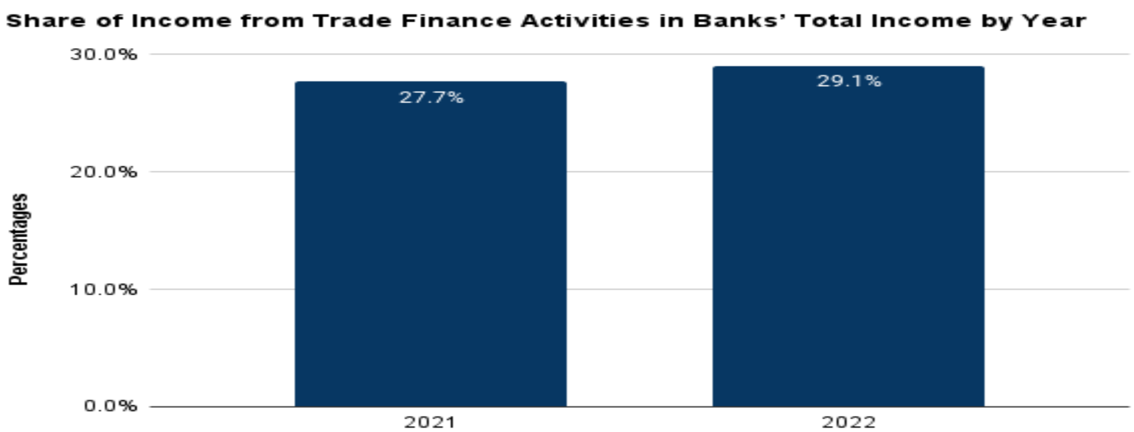


Source: Authors' own computation based on the Bank-level survey data

6.2. Banks' Income from Trade Finance

We inquired banks to tell us the proportion of their total income that came from trade finance activities.[18] On average, income from trade finance activities accounted for about 27.7% and 29.1% of their total income for the period 2021 and 2022, respectively (see Figure 6-3). The finding indicates that trade finance is a lucrative business to commercial banks as its contribution to the banks' total earnings is reasonably large and increasing over the period 2021-2022.

Figure 6-3: Share of Bank's Income from Trade finance activities



Source: Authors' own computation based on the Bank-level survey data

6.3. Trade Finance for SMEs and New Market Entrants

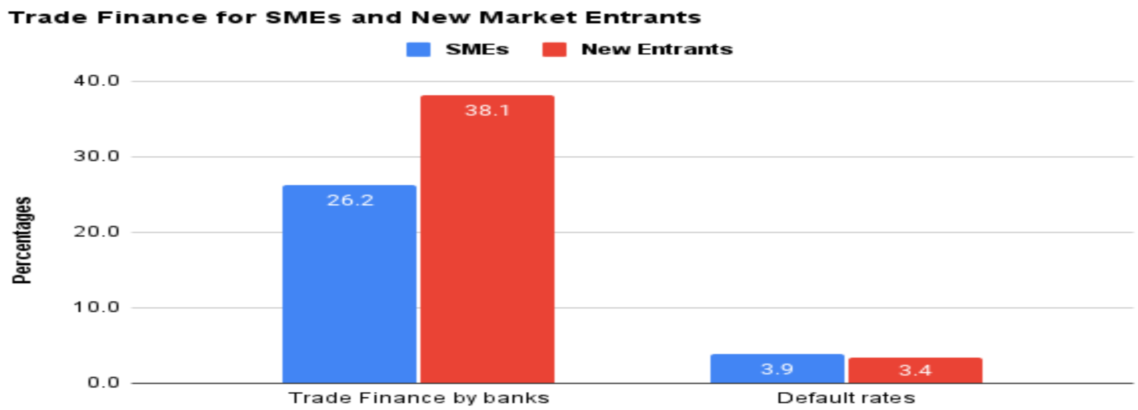
Access to trade finance is critical for SMEs to boost or intensify their international trade activities. However, trade finance often does not come easily for SMEs. DiCaprio et al., (2015) indicate that 52% of SMEs' trade finance proposals were rejected at the time of application, while 87% of large corporations had their trade finance proposals approved. Our survey indicates that SMEs in Ethiopia face similar difficulties in their attempt to access financing for trade. Out of the 18 surveyed banks, only 10 of them provide trade finance for SMEs and 14 give trade finance facilities to new market entrants.[19] Accordingly, in 2022, banks, on average, dedicate 26.2% and 38.1% of their trade finance portfolios to support international trade activities of SMEs and new trade finance customers, respectively. While this could be perhaps defined by the fact that SMEs have a relatively higher default rate in contrast to larger enterprises, it is seemingly not the case for new market entrants, which display a quite low default rate.

[18] [*Q.4.2: What proportion of your bank's total income came from trade finance activities*]?

[19] In this study new customers, refer to those that have for the first time, within the past 12 months, received a trade finance facility from commercial banks.

The survey shows that SME trade finance default rate was about 3.9% and it is reported that, new applicants for trade finance facilities, having an average default rate of 3%, are not necessarily riskier (Figure 6-4).

Figure 6-4: Trade finance for SMEs and New Market Entrants



Source: Authors' own computation based on the Bank-level survey data

6.4. Time to avail trade finance for importers

Report from the firm survey shows that obtaining a commercial bank permit for currency exchange is a burdensome process, which includes obtaining a letter of credit for the total value of an import transaction and applying for an import permit before an order can be placed. The majority of surveyed banks indicated that it takes 90 days (3 months) to avail trade finance especially a letter of credit for the financing of imports. Only one bank reported they only require a day to process the application of legible importers and avail the trade finance for their customers. Overall, the processing time for trade finance applications by banks, average of 33.8 days, shows that there are significant delays in processing applications and availing trade finance for importers. Such delays may occur after the application for foreign exchange joins the queue and the delay related to accessing foreign currency varies across banks in general and also varies across state owned and private banks. Although not supported by our firm survey, expected due to sensitivity of the matter, anecdotal evidence shows that informal payments to accelerate allocation are common while businesses wait in the queue. The recent reforms by NBE, especially in the requirement of reporting queue placements to the NBE, aim at reducing the incidence of informal payments.

Table 6-1: Number of days to avail LC

Number of Days	Banks	Percent
1	1	5.56

3	3	16.67
5	1	5.56
7	2	11.11
9	1	5.56
15	2	11.11
30	3	16.67
90	5	27.78
Average=33.78	Total=18	100.00

Source: Authors' own computation based on the Bank-level survey data

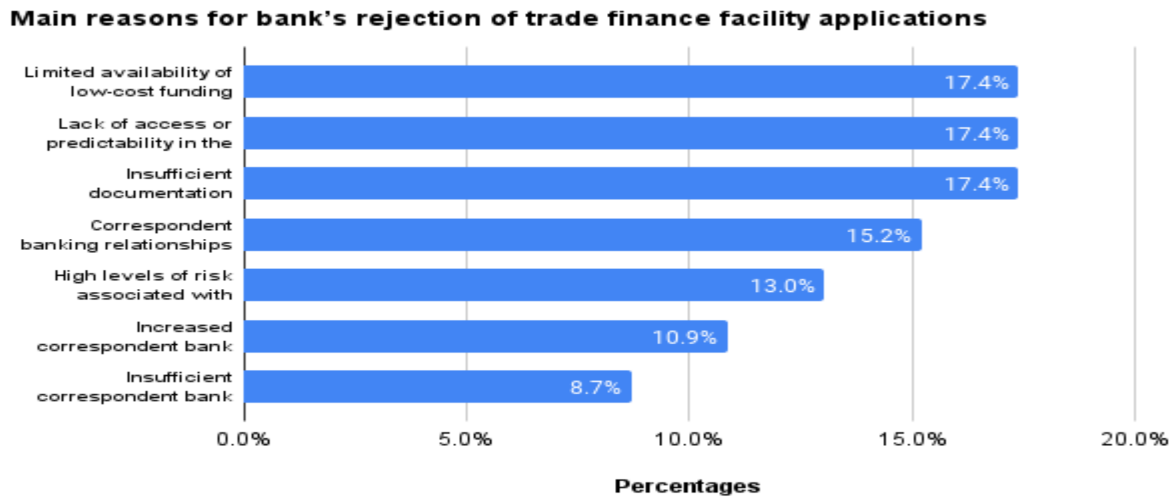
6.5. Trade finance rejection by Banks

Ethiopia had a trade finance gap of US$ 2.1B caused by limited forex, as demand was higher than supply mainly due to lower export commodity prices and mega infrastructure projects taking the large sum of existing foreign exchange reserves (FSD, 2022).

Figure 6-5 shows the main reasons for the rejection of trade finance applications as reported by the banks participating in the survey. Banks cite lack of foreign exchange liquidity as a major constraint to reject trade finance applications. This is obvious, as the bulk of international trade transactions are conducted in US dollars (Goldberg and Tille, 2008). Furthermore, 80% of the denomination of letters of credit is in US dollars (ICC, 2012). It is thus understandable that banks' limited refinancing options in US dollars is indicated as a major barrier to banks' ability to finance trade (Brandi and Schmitz, 2015). This study implies that it is not surprising to expect this, as Ethiopia is currently facing deteriorating foreign exchange reserves. This result suggests that, as the availability of foreign currency on the market becomes limited, banks will have the inclination to reject more trade finance facility applications.

Insufficient documentation is one of the top three reasons cited by banks for rejecting trade finance applications. Trade finance requires further documentation than domestically endorsed facilities, related to customs, transportation, insurance, and other areas. In relation to this, recent studies also indicate that regulatory developments at global level, such as higher know-your customer requirements and anti-money laundering laws, have made the process more difficult. Furthermore, banks in Ethiopia are specifically more constrained by their limited availability of low-cost funding as the most important reason for rejection (Figure 6-5). On top of these, banks in Ethiopia are constrained by the limits in their correspondent bank relations when making the decision to accept or reject trade finance facility applications. Undeniably, this may be perhaps due to the conflict during the period 2021/22 in the nation so that the relationship of correspondent banks is further reduced, which translates into a constraint for banks leading them to reject a higher number of trade finance facilities applications.

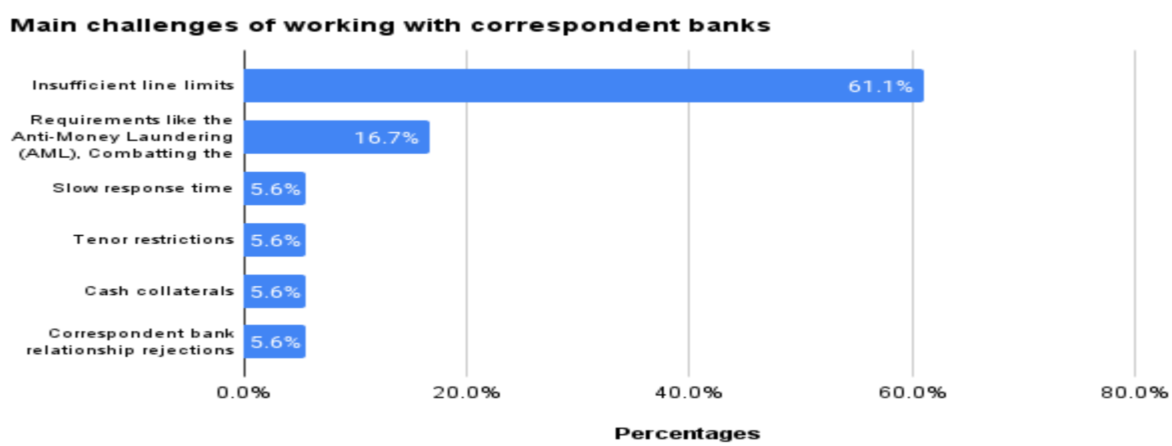
Figure 6-5: Reasons for rejecting credit application by banks



Source: Authors' own computation based on the Bank-level survey data

Further, we enquired banks the main challenges of working with correspondent banks. Nearly all banks reported limitations in executing more trade finance towards working within existing cross-border bank lines to execute individual transactions. Over 60% indicated that they face insufficient line limits and nearly 17% of them cited problems from requirements like the anti-money laundering (AML), while only 5.6% reported correspondent bank transaction rejections (Figure 6-6).

Figure 6-6: Banks' challenges of working with correspondent banks



Source: Authors' own computation based on the Bank-level survey data.

6.6. Commissioning Fees of Banks for LCs

In Ethiopia, Fees are charged by commercial banks, NBE and the SWIFT network. NBE fees are fixed at 1.5% for all foreign exchange transactions. On average, Ethiopian banks included in the survey charge a commissioning fee of 7.76% of the transaction value. A closer look at the bank's ownership structure indicates that charges are significantly higher in private commercial banks. The average fee charged by Ethiopian bank's is much higher than the rate charged by banks in other African countries. This perhaps reflects the scarcity of foreign currency and may be more reflective of the market exchange rate. It may also be a way the banks have found for continuing to make the profits shareholders expect. In our survey, we find that one private bank charges a commissioning fee of more than 10% of the LC value (Table 6-2). The main reason for this is the long waiting time to obtain foreign currency permits from banks. According to feedback from many importers, the foreign currency shortage has also resulted in unequal treatment among importers.

Table 6-2: Bank's charge for Letters of Credit

No. obs (Banks)	Average Commission charges/ fees	Std. Dev.	Median	Min	Max
18	7.76	2.69	9.0	2.5	11.5
Ghana	2.3				
Nigeria	3.5				
Senegal	4				
Cote d'Ivoire	4				
Emerging Markets	2				
Advanced Economies	0.25-0.5				

Source: Authors' own computation based on the Bank-level survey data. Data on average fees charged in other countries is obtained from (AfDB and AFREXIMBANK, 2020).

6.7. Collateral requirement of Banks for trade finance

Contrary to the commonly held perception that trade finance is a risky business for banks, it is a relatively safe business activity for banks as it is backed by strong collateral, based on carefully vetted credit history, have relatively short tenors, and is often self-liquidating where the merchandise itself can be used as a collateral (WTO, 2019).

Despite these, Banks in Ethiopia place strong collateral requirements for trade finance. Half of the banks covered in our survey indicated that their collateral requirements are as high as 100% of the value of the traded goods. Although this can be burdensome for all businesses, its potential impact of barring SMEs from getting access to trade finance is a serious concern. This calls for the need to introduce or accelerate the use of modern financing instruments like Supply Chain Finance (SCF) that use a different approach to risk assessment. While traditional instruments focus more on financials and collaterals, provision of SCF mainly focuses on performance history and strength of relationships in a supply chain (Di Caprio et al, 2017).

Table 6-3: Collateral Requirements of Banks

Number of Banks	Percent	Collateral as Percentage of the transaction value
2	11.11	Don't Know
5	27.78	30
1	5.56	30.5
1	5.56	90
9	50	100

Source: Authors' own computation based on the Bank-level survey data

6.8. Barriers Banks cite to Trade Finance Growth in Ethiopia

We provide evidence to most frequently reported constraints to the growth of banks' trade finance portfolio in Ethiopia.[20] Recognizing the factors that limit the growth of banks' trade finance portfolios is a significant step needed for policymakers to be able to properly design and implement policy interventions that can ease access to trade finance. The most frequently reported impediments to the growth of banks' trade finance portfolios in Ethiopia are limited foreign exchange liquidity (30.8%), regulatory restrictions (26.9%), political instability (13.5%), competition (11.5%) and insufficient limits with correspondent banks (11.5%), followed by lack of sufficient risk capital (3.9%) and limited staff capacity (1.9%) (see Table 6-4).

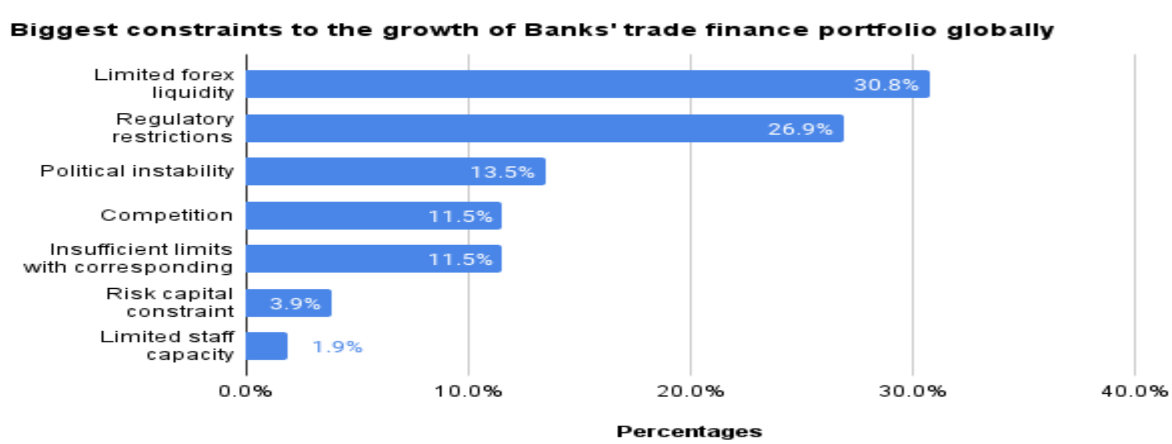
Limited foreign exchange liquidity poses significant challenges to the growth of banks' trade finance portfolio as the country is facing dwindling foreign exchange reserves. Regulatory restrictions also present sizable constraints to banks and are among the main challenges to expanding their trade finance portfolios. We provide insights into the challenges of regulatory restrictions from two perspectives; domestic and global. First, opinions obtained from banks during the survey indicate that NBE's directive on foreign exchange retention rate caused detrimental effects on the supply of trade finance. Second, the international standards, particularly anti-money laundering (AML) and KYC rules have become more stringent and maybe even more so, when banks will have to comply with Basel III requirements. The survey does not capture information that could help us assess whether regulatory challenges pointed out by the banks are related to the international standards issues. We can easily recognize that such requirements may lead global banks to reduce their trade finance activities in Ethiopia. Similarly, research from surveys done by the Asian Development Bank (DiCaprio and Yao,2017) indicates that AML and KYC requirements are among the primary barriers for issuing banks.

[20] [*What are the biggest constraints to the growth of your trade finance portfolio globally*?]

Political instability is considered one of the main challenges that constrain the growth of banks' trade finance portfolios. Ethiopia's conflicts and instability may result in the weakening of the performance of the financial sector and deteriorate banks' ability to sustain financial intermediation and payment systems. Consistent with this, a study by Huang (2019) confirmed that political instability worsens banks' balance sheets, creates ineffectiveness in the operational management of banks and affects asset and liability allocation. While competition is good for the trade finance environment as a whole, increased competition will put a strain on the market shares of individual banks and may undermine the extent and volume of trade transactions, and is likely to be a cause of serious concern in such banks.

In our survey, 11.5% of banks reported that competition is a major constraint to the growth of banks' trade finance portfolios in Ethiopia. Limited correspondent banking relationships is also considered as one of the constraints for the growth of trade finance portfolios. More than 11% of banks reported challenges with correspondent banking relationships—networks of financial institutions in different countries providing each other with services - as one of the reasons constraining the growth of banks' trade finance portfolio globally. These are important to issuing, confirming, and settling cross-border trade finance transactions. Growing export penetration and the sourcing of inputs from international markets demand bigger networks of correspondent banks. A perception of increased risk in either country involved in the transaction can prompt a correspondent bank to reduce line limits, increase reporting requirements, or raise fees. A fewer number of correspondent banking relationships causes trade transactions to be more vulnerable to such instances of worsening terms.

Figure 6-7: Banks' constraints to growth of trade finance portfolio

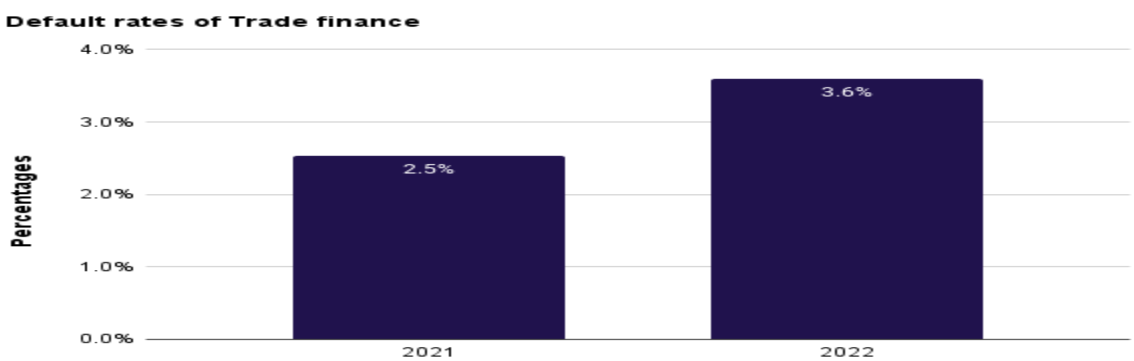


Source: Authors' own computation based on the Bank-level survey data

6.9. Trade Finance Risk in Ethiopia

Trade finance has numerous risks related to it and there are several reasons for this. In contrast to risks related with other bank activities, trade finance seems to be less risky. Evidence from the ICC (2013) the global default rate on trade credit for international transactions is below 1% but default rates of trade finance transactions in developing countries in general and Africa in particular are likely to be higher due to the existence of market imperfections. This is in fact corroborated by results from our banks' survey. Figure 6-8 shows the default rates on trade finance activities in Ethiopia over the period 2021 and 2022. On average, the default rate on trade finance activities in Ethiopia is 2.5% and 3.6% in 2021 and 2022, respectively. This is relatively lower than the 8% average default rate on trade finance portfolios in Africa (African Development Bank, 2020). This can partly be explained by the stringent requirements and thorough selection of borrowers process banks in Ethiopia use to provide trade finances.

Figure 6-8: Default rates of Trade finance in Ethiopia



Source: Authors' own computation based on the Bank-level survey data

6.10. Policies, Rules and Regulations that limits banks' provision of trade finance

Our survey uncovered the major barriers banks face to making trade finance available to their clients. The majority of banks raised the challenges posed by the NBE retention requirement as a serious impediment to providing trade finance to their customers. In relation to this, banks mentioned the lack of stakeholder consultations on the part of the NBE during policy and directive design and implementation. NBE regularly releases amendments to existing streams of Directives as well as new streams of Directives. The Directives are drafted at high levels of management within NBE, after consultation with other Ministries, Departments and Agencies and are approved and signed by the Governor. Private banks and businesses do not have formal channels through which they can be consulted or advocate changes to the Directives. Private banks and businesses consider their involvement in the ex-ante and ex-post appraisal of the Directives as a mechanism through which the Directives and their implementation can be improved. The banks also complain about the lack of transparency in foreign exchange approval by NBE as their challenge to entertain the requests of the majority of their customers. The other directive of the NBE that banks consider to have lessened their capacity to extend trade finance to their end users is the minimum price directive on exports.

Table 6-4: Reasons banks cite to avail trade finance

Barriers	Number of Banks
Surrender directive of NBE	18
Lack of transparency in foreign exchange approval	1
Minimum price directive	1
High foreign currency account utilization	1
Single borrower limit	1
Bill NBE impose on trade finance	1

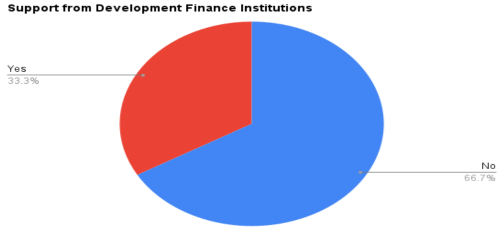
Source: Authors' own computation based on the Bank-level survey data

6.11. Development Finance Institutions (DFIs) support to the Banks

Since 2013, Development Finance Institutions (DFIs) like the AfDB, Afreximbank, and IFC play an important role in Africa's trade through the provision of short-term financing for working capital and credit guarantees by focusing on SMEs. These programs aim at increasing foreign banks' exposure to – and confirmation volumes from – African issuing banks (AfDB and AFREXIMBANK, 2020). Accordingly, the study indicates that an average of 60% of banks in Africa that are engaged in trade finance received support from DFIs. In this section, we make effort to see if Ethiopian commercial banks participating in trade finance activities received support from DFIs.

In Ethiopia, thirty-three percent of banks received some kind of trade finance related support from DFIs. Backed by government funds and guarantees ensuring their credit-worthiness, DFIs can raise large amounts of funds on international capital markets to provide loans or equity investment on competitive, even subsidized, terms. So, the role of DFIs is a significant step to scale up the flow of trade finance in Ethiopia particularly to the largely excluded SMEs.

Figure 6-9: DFI's Support



Source: Authors' own computation based on the Bank-level survey data

7. Conclusion and Recommendations

The study presents findings on the trade finance environment in Ethiopia with the aim of exploring the major challenges and possible solutions for promoting access to trade finance in Ethiopia. We specifically look into problems/challenges that limit access to trade finance among importing and exporting firms as well as factors that limit banks' provision of trade finance services. Moreover, the study attempts to identify factors that lead to high logistics costs and time in Ethiopia. To this end, the study reviews relevant studies and policy documents and conducts an analysis of survey data collected from 18 commercial banks and 285 importing and exporting firms across multiple sectors.

To highlight the key findings, firms cite insufficient collateral, limits on bank capital, and lack of hard currency as the main reasons for their trade finance application rejections. These factors are consistent with why commercial banks reject trade finance applications. Banks state firms' creditworthiness and insufficient collateral as the main reasons for rejecting firms' trade finance applications. We also observe that a larger proportion of firms, the more so SMEs, exclude themselves from the trade finance market - probably discouraged by the higher likelihood of application rejections.

Moreover, the trade finance landscape is characterized by the high cost of existing instruments, limited availability and awareness of emerging solutions to trade finance instruments. The trade finance market is dominated by traditional, unfunded instruments and the use of modern instruments like supplier finance, factoring and forfaiting as well as risk-mitigating instruments like credit guarantees (important to pre-shipment finance in particular) is significantly limited. Addressing these barriers needs rigorous effort and interventions from stakeholders to ease both the supply- and demand-side constraints.

7.1. Policy Recommendations and Way Forward

Improvements in the trade financing ecosystem is envisioned to play an important role in bridging financing gaps facing importers and exporters. The main actors and key players in the trade finance landscape including logistics solutions and technology providers, financing institutions, along with government bodies need to innovate and make the process more efficient to enhance accessibility and reduce transaction costs. It has to be well-noted that digital solutions and collaboration will be key in driving momentum. Creating sufficient financial infrastructure and containing credit information systems, will be necessary to de-risk transactions and heighten banks' ability to supply trade finance.

Mitigation of risks associated with Trade finance:

- mitigation of trade finance risks by promoting cooperation between public and private sector actors in trade finance;

- offering capacity building to financial service providers (i.e. some private commercial banks were proposing this in our survey) in case of newly emerging solutions to trade finance and better understanding the technicalities. In order to reduce high country risk perception, developing and introducing risk-mitigation tools and facilities such as guarantees as well as enhancing the readiness of the financial service providers to invest and incentivize the use of emerging trade finance solutions. To make this recommendation workable, first, banks must be properly incentivized to decrease rejection rates and offer more trade finance to their customers. This may require an active involvement and coordinated effort by development financing institutions partners like the World Bank, IMF, IFC and African Development Bank, national trade promotion agencies, donor agencies and other development finance institutions in addressing well-known challenges, such as low creditworthiness and insufficient collateral.
- It is known that defaults on trade finance are low, as confirmed by banks, resolving the creditworthiness and collateral concerns will enhance banks in the trade finance sector to scale-up the supply of trade finance. While portfolio guarantee instruments offered by DFIs have been useful, their objective is to provide comfort to international banks to increase the trade finance to local banks in the hope that these banks will then extend more financing to firms. DFIs and other agencies should offer local banks guarantee instruments that directly cover the default risk of firms. These could be in the form of first-loss partial guarantees or risk sharing guarantees at the firm level between the banks and DFIs.
- Moreover, as a benchmark Ethiopia can adopt Ghana's experience of reforms to upgrade its credit infrastructure by facilitating the operation of private credit bureaus and the setting up of a national collateral registry. Such reforms, embarked upon by several countries[21].
- The use of alternative trade finance instruments such as factoring and Supply Chain Financing (SCF) that are well established in other parts of the world should be more vigorously pursued in Ethiopia.

Technology solutions:

- digital solutions symbolize the main issue in increasing access to trade finance in Ethiopia.
- Creating partnerships with blockchain associations for informing the financial service providers on available Distributed ledger technology (DLT) solutions;

[21] See Triki and Gajigo (2012).

- Offering financial support to local technology providers to enable them to engage with cloud providers to develop local, cloud-based DLT as a mechanism of addressing the high implementation costs of DLTs; and – lastly –
- offering ‘fintechs’ and ‘tradetechs’ with the financial support required to use solutions like the SWIFT MT 798 tailored to the operating realities of SMEs in Ethiopia. This will serve to enhance financial service providers- import and export firms’ inter-linkages and encourage trade finance automation and greater ‘pooling’ of trade finance requirements.
- To reduce delays and minimize bureaucracy in transactions and document processing, promotion of digital solutions across trade value chains and trade finance is critical. Surveys both from banks and firms indicated delays in the processing of transactions as a significant challenge in usage and access to trade finance. Digitization could lessen the cost of finding and confirming trading counterparts, substantiating the authenticity of transaction documents, minimizing the duplication of efforts in processing of documents for both firms and banks, and reducing transaction costs.
- It is also recommendable that banks should extensively streamline their internal processes to advance electronic processing and further the approval of trade finance transactions. This should also be supported with appropriate national and global regulatory frameworks to bring the expected impact (International Chamber of Commerce, 2020). NBE should also refer to guidelines recently spearheaded by the International Chamber of Commerce on how national regulators could build on the positive efforts made by banks. That could serve as a good starting point for governments to coordinate efforts with MDBs, logistics and shipping companies, banks and fintechs to speed up the digitisation agenda.

Regulatory reform:

- another important area needed to enhance the trade finance market is regulatory reform. Here, it is important to introduce reforms aimed at enhancing the ease of doing business in trade finance value chains which includes initiating and designing the enabling legal frameworks for the uptake of trade finance instruments and emerging solutions (i.e supply chain finance) such as factoring and warehouse financing; addressing compliance constraints relating to KYC and AML, for instance by applying a risk-based approach through a tiered system; and overcoming the challenges of foreign exchange liquidity through the design and implementation of policy reforms that facilitate a more flexible FX regime. The regulatory reform should also take into account the hot issues at the top agendas of both firms and banks in our survey, demanding the revision of the retention account directives by NBE.

Enhancing trade infrastructure:

- upgrading trade infrastructure can also be taken as one of the key policy recommendations. In order to enhance and increase the use of structured commodity finance, it is viable to make a significant amount of investment in storage facilities such as warehouses and cold storage and leverage market intelligence to identify the strategic placement of these facilities.
- In an effort to promote agricultural exports, it is also worthwhile to expand commodity exchanges for aggregation of farmer produce, access to collective financing and trading of warehouse receipts. These measures also in turn help to reduce costs associated with logistics and improve the overall logistics performance of the economy.
- Developing alternative trade corridors to increase logistics movement across countries and lower costs for exporters; as well as to provide targeted TA to banks to help deepen understanding of the value proposition on trade finance for SMEs.
- Capacity-building initiatives are essential on both the supply and demand side. On the supply side, banks need to have the requisite capacity and skills to appropriately assess the trade finance needs and associated risks. Innovative schemes and new funding instruments that directly address some of the challenges firms face are also needed. Through trust funds, donor agencies, internal resources and cost-sharing mechanisms, Multilateral Development Banks (MDBs) and other relevant institutions should help build the capacity of banks in such key areas as trade finance product knowledge and development of proper risk management frameworks and models. On the demand side, firms engaging in import and export trade are required to build their capacity on different trade finance instruments and options available for financing exports and imports. Financial as well as the overall management capacities of firms need to be strengthened, mainly for SMEs that face higher rejection rates. Strategies to help SMEs develop better risk and capital management systems are needed to ensure that they can easily access finance, meet their financial obligations, and take on sustainable debt to stay creditworthy. Multilateral Development Banks (MDBs) like the African Development Bank, other development financing institutions (DFIs) and trade organizations such as the International Trade Center and World Trade Organization (WTO) can offer the technical assistance on enterprise financial management upgrading, pre-

qualification assessments, and debt-servicing strategies to enterprises in developing regions (International Trade Center, 2014).

Enhancement of competitive advantage of SME's:

- Lastly, it should be well-noted that interventions aimed at enhancing the SME's need to be considered as a critical area of interventions. This may include training and capacity building programs to enhance SME competitive advantage for leveraging cooperatives and industry associations to address weak market linkages. Additional opportunities exist in improving access to digital-driven services and international cooperatives; and boosting quality standards for increased trade.

7.2. Policy Recommendations to Key Stakeholders

Financial service providers:

- Financial Service Providers (FSPs) play a significant role in creating access to the capital and other financial services that firms require to facilitate their trade activities. This study proposes to introduce technology innovations that FSPs should take into account in order to develop the affordability and effectiveness of service provision to firms engaged in the international trade; this could involve the partnerships between bank and non-bank service providers i.e fintegration. The report also calls out opportunities for FSPs to tailor instruments provided to help them meet the demands of firms engaged in import and export activities better, such as providing the rolling facilities that take into account the production cycles for exporters, and import cycles for importers.

National Bank of Ethiopia (NBE):

- NBE plays a critical role in creating the broader enabling environment required in supporting sustainable longer-term growth of trade finance. Specific opportunities exist for NBE and policymakers in several areas including developing legal frameworks to support innovation and fintechs, addressing compliance challenges and foreign exchange liquidity gaps. NBE should take an initiative to revise the 70-30 retention directive which is considered to be challenging the trade finance market as firms echoed NBE to increase the rate to 50-50.
- The National Bank of Ethiopia should also conduct assessments on foreign currency utilizations considering the specific nature of subsectors. Exporters engaged in the supply of items sourced from Ethiopia may not be affected by the changes since they purchase export items from local suppliers in Birr. However, businesses that source raw materials, inputs, and services from the

international market cannot operate unless enough forex is allocated for utilization. Hence, the National Bank should adopt sector-specific forex utilization regulations.

- Again, our survey from banks also showed that the National Bank is amending its directives without consulting the private sector and stakeholders like banks. The National Bank should implement an appropriate consultative process with the private sector when drafting directives that impacts private enterprises and their operations. Furthermore, NBE in collaboration with institutions working on the logistics sector i.e Ethiopian Maritime Authority can also play a crucial role in developing the supporting infrastructure and policy framework to develop warehouse financing.

Development Finance Institutions (DFIs):

- Development partners play a critical role in creating the further enabling environment needed to provide sustainable longer-term growth of trade finance. Specific potential areas of interventions are present for development partners in different areas including providing a dynamic risk-mitigation solutions (e.g., revolving funds, risk guarantee facilities) critical, supporting regulators in developing and adopting policy frameworks for trade finance products (e.g., factoring laws which are largely lacking in Ethiopia) and providing financial support to FSPs to adopt technology innovations such as electronic documented solutions (i.e electronic bills of lading) and Distributed Ledger Technologies, given the high cost of adoption.

SMEs:

- The report identifies opportunities for SMEs to improve their competitiveness in order to increase their eligibility for trade finance products as well as highlights examples of technical assistance programs that SMEs can participate in to enhance their competitiveness including, support in identifying competitive value chains, designing internal operating systems and processes, and improving access to digital-driven services.

Other players:

- **I**ndustry associations (i.e major exporters associations, Ethiopian Chamber of commerce, Ethiopian freight forwarders association and alike) play a significant role in creating the broader enabling environment needed to support sustainable longer-term growth of trade finance. Specific opportunities exist for these players in several areas including enhancing linkages to regional and international export markets, sensitising firms in the export and import market on existing trade finance products and how they work as well as compliance with sector standards, and collecting the market intelligence needed to better understand firms’ trade finance needs.

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