

# THE EFFECT OF GLOBAL FINANCIAL CRISIS AND ETHIOPIAN MONETARY POLICY MEASURES: REVIEW ON THE PRE-AND POST-CRISIS SCENARIO

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## Abstract

Policymakers and leaders usually fail to grasp a sound lesson from the economic hurdles and crises countries face. This paper, thus, is intended to review and articulate the causes and effects of the global financial crisis, and how the Ethiopian monetary policy reacted and mitigated the crisis. The data for the analysis were collected from various sources including IMF, World Bank, National Bank of Ethiopia, and research articles from 2003 to 2019. The review reveals that even during the crisis in 2009, Ethiopia was among the top five fastest-growing countries in the world by an average of 10.5%, which is twice the average growth of Sub-Sahara African countries (5 %). It had become the seventh-largest economy in Africa and the 69th in the world with a GDP PPP of 118.2\$ Billion as of 2013. Some of the main reasons for the continued growth of the country amid crisis could be the desynchronization of the country's financial market with the international financial market, an insignificant share of mortgage loans in domestic financial sector services, and high-level government-led infrastructure investment coupled with China's economic alliance. However, the significant effect of the crisis was observed in the country's exports, remittance, and Foreign Direct Investment (FDI). To shun the related inflationary effect, the government increased the minimum deposit interest rate, reserve, and liquidity requirements, and reinstated the credit restrictions. Also, the immediate alert was given to commercial banks to give proper attention in managing credit risk and reducing non-performing loans to below 5% and overdraft facilities. Given the above-mentioned facts, the monetary policy measures were effective to stabilize the economy & sustain the growth. In the end, the offshoots & setbacks of the unsynchronized financial market, government-led investment & fettered mortgage loans are addressed, and the way forward is marked out.

## Keywords

*Monetary policy, Global financial crisis, Subprime Mortgage, FDI, labor market, Ethiopia*

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## Introduction

In the history of the global economy, in 20<sup>th</sup> and at the advent of the 21<sup>st</sup> century, the four salient features have taken place: the 1930s' Great Depression, the 1980s' Latin American debt crisis, the 1997/98s' Asian Financial crisis, and the recent global financial crisis of 2007/08. It was noticed that the great depression of 1930 evolved with a slide of the New York Stock Market in 1929. The collapse of the stock market was caused by a decline in the value of assets in the credit portfolio of banks. As the consequence, 11,000 out of the 25,000 banks in the USA had faced bankruptcy in 1933. The severity of the depression effect was not limited to the USA but also spread to other developed countries. Thus, it led to a 50% decrease in the industrial outputs in the USA, a 33% lay-off rate in Germany, and a 25% export decline in Great Britain (Kindleberger, 1986; Paul, 2010).

Most importantly, the Great Depression and the Global Financial Crisis have at least three things in common (OECD, 2009). First, both were originated from the same country, the USA. Second, both were amplified by the conditions in the financial markets. Third, both were shortly transmitted to other countries and become global phenomena. The financial crisis is a problem related to the limited supply of money or financial resources and when the demand exceeds supply and liquidity becomes challenging for market actors (Pop, 2009; Neuhauser, 2015). The financial crisis of 2007 – 2008 was triggered by the decline in prices of residential properties (houses) in the USA at the end of 2006 and the beginning of 2007 (Pop, 2009; Verick and Islam, 2010; OECD, 2009; Assefa, 2019). The crisis was also called the subprime mortgages (Pop, 2009). Subprime mortgage /lending is making loans to people who may have low credit ratings and difficulty in maintaining the repayment schedule due to setbacks such as unemployment, natural calamities, social issues like divorce, and medical emergencies (Heyford, 2019). Then, while the decline in the prices of houses started, it became too much challenging for the banks to refinance those mortgages. The banks, at the same time, attempted to reset adjustable mortgage rates to a higher level which all together created a repayment problem for subprime borrowers (Pop, 2009; Ngowi, 2010; Griffith-Jones). Commencing in mid-2007, the financial crisis immediately metamorphosed from the US crackdowns on the house mortgages to the worst recession that the world has ever encountered for over six decades. Besides, some of the complex and interlinked factors behind the emergence of the crisis in 2007 were lax financial regulation and misperception of risk, global imbalances, and loose monetary policy (Verick and Islam, 2010; Cornelia, 2009; Assefa, 2019; Neuhauser, 2015).

Different scholars and economists have debated much about the possible causes of the global financial crisis of 2007/2008 (Verick and Islam, 2010; Gál, 2011; Pop, 2009). Subprime mortgages have been pointed out as the first obvious cause of the crisis (Pop, 2009). He also argues that structured finance products and credit derivatives as the second obvious cause of the crisis because they (derivatives) intensified the transmission of risk and losses among banks and market actors. The securitization, which is structured finance, unprecedentedly increased the interconnectedness

among financial institutions, while globalization elevated the integration of financial entities across countries. Both increased the diffusion of toxic products to banks around the world that aggravated the geographic spread of the crisis (Pop, 2009; OECD, 2009; Neuhauser, 2015).

Some of the main factors behind the crisis are identified as loose monetary policy in terms of interest rates, misperception of risk, lax financial regulation, and global imbalances (OECD, 2009; Verick and Islam, 2010; Gál, 2011). From mid-2003 to mid of 2004, the interest rate was just 1 percent in the USA. Then from the end of 2004 until the first mid of 2007 it was sharply increased and reached the peak, then during the recession period, it has fallen approaching zero level until 2009 (Verick and Islam, 2010). Unnecessary competition among banks pushed them to increase market share by giving loans to unqualified low-rating households. Thus, the inability of many US households to pay back their mortgage loans has triggered a financial crisis, which reduced to zero the value of the associated mortgage-backed securities (OECD, 2009; Assefa, 2019; Ngowi, 2010).

In the United States, generally, the three key players involved in the global crisis are government, financial institutions, and households. On the government side, measures such as financial deregulation of the 1990s onwards and liberal monetary policy adopted between 2002 to 2005 immensely contributed to the occurrence of the crisis. The intensive USA government interference in housing finance drastically increased moral hazard. Also, the huge incentives set up by the government initiated all actors to take excessive risk from Wall Street to Main Street ((Verick & Islam, 2010; Gál, 2011; Neuhauser, 2015); Whereas, on financial/housing agency side, actions such as using over-the-counter transactions, off-balance-sheet entities (SIVs) and complex securitization of assets (CDOs) that enabled banks to pass away risks without prudence. Also, the securitization is coupled with the failure of credit rating agencies in assessing risk accurately, shallow risk analysis/assumptions, remuneration incentives that encourage risk-taking, excessive leverage and reliance on short-term debt (repo), and aggressive and poor mortgage lending standards. On the other side, the overambitious goal of households in borrowing beyond their means led to failure to repay the loan that provoked the crisis (Verick & Islam, 2010; Neuhauser, 2015). The borrowers had no or less personal liability for the debt and they could choose from a package of mortgage services with different interest rates and attractive terms of amortization periods and low down-payment (Gál, 2011; Verick & Islam, 2010; Neuhauser, 2015).

Altogether, the combination of the above-mentioned factors and low returns on the other assets fuelled the excessive leverage and investment in risky assets, namely the mortgage-backed securities. In this case, we see that sub-prime mortgage was at the center of the crisis but was not the only cause (Verick and Islam, 2010). The perception of risk was distorted by two factors: the interest rates were low and the increasing of housing prices every year from 1991 until the second half of 2006 (Pop, 2009). The unprecedented appetite of the Middle East and export powerhouses – led by China, for scaling up reserves of foreign exchange in US dollar-exchanged assets

(typically low-yield US government bonds) enabled the persistence of low-interest environment in the US (Zsolt Gál, 2011). Thus, this had given birth to ‘global imbalances’ that pertain to the ‘excessive consumption of deficit countries (led by the US) and ‘excessive savings of surplus countries’ (led by China). Also, the global imbalance can be manifested in terms of financial flows where developing countries benefited more from international capital flows, FDI, and could build up vast foreign currency and reserves (OECD, 2009, Neuhauser, 2015).

Ethiopia is one of these developing countries which attracts high FDI and relies on foreign aids. Ethiopia has been one of the fastest-growing economies in the world and it has grown by a double-digit average of about 10.5%, twice the average of Sub-Saharan African countries, which is 5%. But the effect of the financial crisis on the Ethiopian economy has been debatable as the country is not yet directly participating in international financial markets that include stock exchange markets. However, the effect was inevitable and multifaceted. For instance, the commercial bank of Ethiopia experienced substantial setbacks in terms of loan dispersed for importers (LI) (214%), interest income from the foreign deposit (217%), ROA (16%), total revenue from international banking activities (39%) decrease (Assefa, 2019). The author of the current study observed only three relevant papers: Asfaw (2018), Assefa (2019), and Megersa, & Cassimon (2015), published in reputable journals concerning Ethiopia. This could lead to failure in drawing a proper lesson from the crisis, which most likely makes policymakers and leaders give wrong justification and conclusions. Hence, in this paper, an attempt is made to briefly elucidate the causes and effects of the global financial crisis and the Ethiopian government monetary policy measures. The following questions are, specifically, attempted to be answered: how did the global financial crisis affect the Ethiopian economy relative to other economies? And what were the monetary policy measures implemented by the government to resolve the impact of the crisis? The next sections portray the research methodology and the general outlook of the monetary policy frameworks and objectives. Then, it briefly deals with the general economic growth of the country. Thirdly, it shortly discusses the financial crisis causes and consequences. Fourthly, it addresses the effect of the crisis and the possible monetary policy measures taken as the responses. Finally, the conclusion is drawn, and ways forward are underscored.

### **Research Methodology**

It seems hard to obtain full-fledged scientific researches from databases that address the causes and effects of the crisis on FDI, aid, foreign trade, remittance, and the economy in general, and the respective policy responses, especially for developing countries. This study, thus, follows a narrative approach by adapting a comprehensive review of literature, which is commonly used to fill research gaps by inculcating studies and reports from all authentic sources to create a clear and all-around picture about a subject (Littell, Corcoran, & Pillai, 2008). To garner scientific works (if any), the key topics applied for the search of articles are *the causes and effects of the global financial crisis, the effect of the global financial crisis on Ethiopian economy or busi-*

ness, and the Ethiopian monetary policy measures or response to mitigate the global financial crisis. Surprisingly, from EBSCO and Web of Science database search using the term *Global financial crisis and Ethiopia*, only three relevant research articles: Asfaw (2018), Assefa (2019), and Megersa, & Cassimon (2015) were found. This implies that the causes and effects of the global financial crisis have not been well addressed in the Ethiopian context and, if that is the case, the appropriate lesson from the crisis has also been not grasped. Hence, in addition to research articles published from 2003 to 2019, the data were collected from both international as well domestic organizations databases like the International Monetary Fund (IMF), World Bank, and National Bank of Ethiopia websites. Studies selection is based on a snowball technique in which a search continues from an article to another article to trace out all the viable records. Based on the data obtained, the effect of the crisis, especially, on inflation, foreign direct investment, export and import, foreign aid, foreign exchange, labor market, and remittance are addressed to show how the monetary policy measures of the country mitigated these effects on the economy. As shown in Figure 1., the study addresses the causes of the financial crisis, the areas of effect of the crisis, and the role of monetary policy measure as a moderator of both the causes of the crisis and its effects on the economy.

### Overview of Ethiopian Monetary Policy

According to Ethiopia Federal Democratic Republic government proclamation number 591/2008, the monetary policy of Ethiopia is controlled by the National Bank of Ethiopia (NBE) (Abate, 2008; National Bank of Ethiopia, 2009). The NBE has a board of directors with the chairman and its governor who work as the main executive body. The governor establishes the Monetary Policy Committee (MPC), which

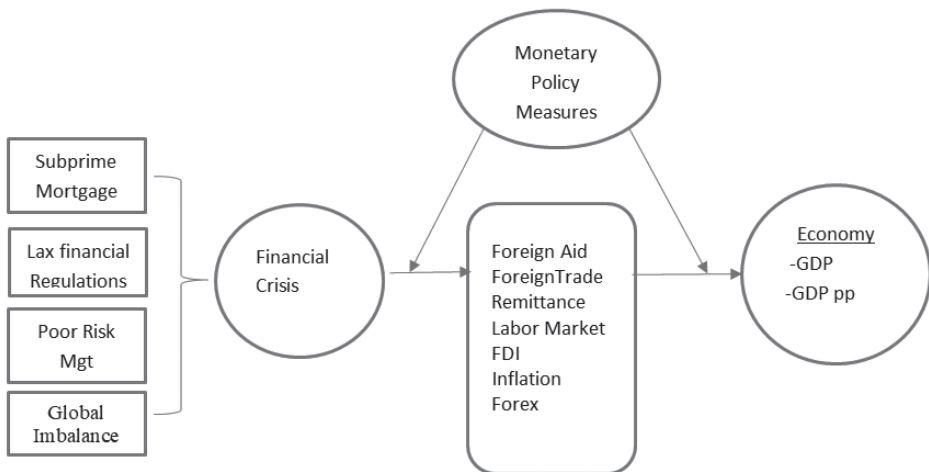


Figure 1. The Conceptual Framework of the Study. Source: Own Review, 2021

formulates policies and evaluates the proper implementation and impacts of policies. According to the proclamation, the bank is accountable to the Prime Minister of the government (NBE, 2009).

The monetary policy denotes regulatory measures and a bundle of actions used by the national bank including, but not limited to (Abate, 2008; NBE, 2009, 2019):

- determining the minimum rate of interest on deposits or the rate of rediscount imposed on commercial banks
- deciding on the level of required total deposit reserve of commercial banks
- changing commercial banks' reserve holding through sales of government securities and open market purchases
- regulating commercial banks' financial activities in setting minimum level capital requirements; and
- intervening in foreign exchange markets

In line with these duties, Ethiopia's monetary policy works on the following objectives:

- To ensure the conduciveness of monetary, credit, and financial conditions for sustainable economic growth
- To maintain the national currency's purchasing power by determining the level of money supply and controlling foreign exchange rate market
- To catalyze and ensure the efficient allocation and mobilization of domestic and foreign savings for productive economic activities
- To ensure the emergence and growth of capital and financial markets and their fit in meeting the needs of the economy
- Moreover, maintaining the price & stabilizing the exchange rate are the main objectives of the monetary policy of Ethiopia (Abate, 2008; NBE, 2009; 2019).

One of the key indicators of macroeconomic stability is price stability, which plays an indispensable role in the private sector's investment decision making, households' consumption as well as international trade and savings (Abate, 2008). Besides, maintaining exchange rate stability determines the competitiveness of domestic firms in the international market and exerts a huge influence on both import and export items. Using exchange rate intervention as a tool for monetary policy is also found to affect both foreign reserve position and domestic liquidity (Abate, 2008). To achieve its final target of maintaining price and exchange rate stability, the monetary policy considers achieving the optimum quantity of money supply as an intermediate target (NBE, 2009). To cope up with the economic situation of the country, managed floating exchange rate regime has been practiced in Ethiopia since 1992. It is also expected to be continually implemented in the years to come (NBE, 2009). The bank interest rates are not fully liberalized in Ethiopia. The National Bank of Ethiopia determines the minimum rate of bank deposit while other banks, including state-owned and privately owned, can set all lending and deposit rates above the minimum. So far, between January 1999 and July 2008, the

minimum interest rate has been adjusted only twice as a response to the crisis, but the average rate of deposit has been changed a few more times (Loening, Durevall,& Birru, 2009).

### The General Economic Growth in Ethiopia

Since 2004, the last more than one decade, Ethiopia has been one of the fastest-growing economies in the world and it has grown by a double-digit average of about 10.5% to 11%, twice higher than the average Sub-Sahara African country, which is 5 percent (UNIDO, 2013; Ethiopia Country Report, 2014 and Tekeba, 2018). It had become the seventh-largest economy in Africa and the 69th in the world with a GDP purchasing power parity of 118.2\$ Billion as of 2013 (Tekeba, 2018). The Ethiopian economic growth scenario conforms to Keynesian and structuralism concepts of development and it has adopted developmental state policy (Priewe, 2016). Since 1992, the country has been following Agricultural Development leads Industrialization Policy (ADLI) and intensively working to transform agriculture into industrialization (National Planning Commission, 2016). Ethiopia is the only country in Sub-Saharan Africa and, perhaps, even worldwide which remarkably grows out of subsistence agriculture, without special natural resource endowments like oil, with the integration of public investment and positive terms of trade (Priewe, 2016). The key to this achievement is believed to be the adoption of the idea of a “developmental state” that successfully guided Asian tiger economies like China, Japan, Taiwan, Korea, and Singapore to a sustained high growth trajectory. From 1992-2003, a very insignificant per capita growth was observed. GDP per capita grew by 8.0% p.a from 2003 to 2014, showing an increase of 2.3-fold; overall GDP increased by 10.9% p.a. (Priewe, 2016). Figure 2., shows gross investment and savings since 2000.

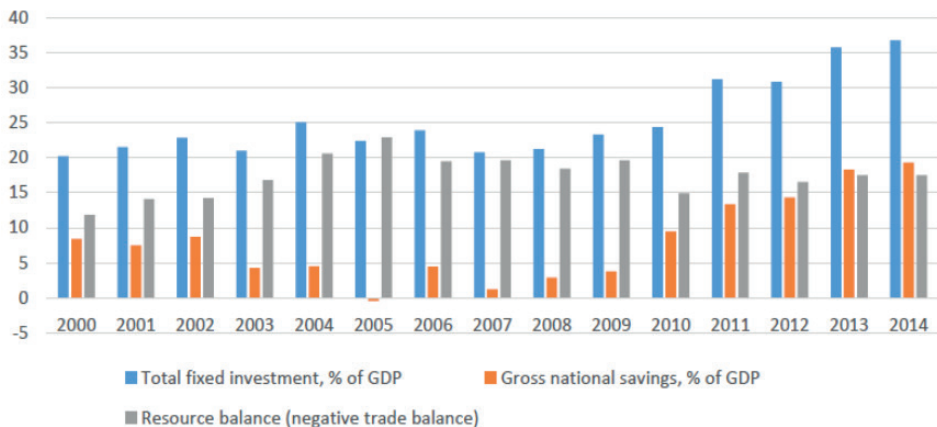


Figure 2. Gross Investment and National savings pre and post-global crisis period. Source: Priewe, (2016) and National Bank of Ethiopia, (2015)



In Figure 2., above, we see the national savings and gross investment six years before and after the global crisis of 2007/2008. The term “national savings” is simply means the share of output remains unconsumed by households or the government. It is misleading as it does not indicate the true financial positions of the country. The share of “national savings” got shrink until 2007 and elevated afterward up to 19% of GDP in 2014. Nevertheless, we do not have enough evidence to say that the shrink in national savings was due to the crisis, there might be other economic reasons like productivity decreases. Next, as shown in Figure 2, the gross investment is almost twice the share of GDP from 2000 to 2014, approaching 37% of GDP (Priewe, 2016). During the crisis it showed slowdowns but soon after, 2009, we observe steadfast growth.

Below, Figure 3. shows that there is a significant gap between export and imports, 9.8% and 27.3% of GDP, respectively. This simply indicates that the amount of goods or values of goods Ethiopia imports exceeds the export. However, we do not see a remarkable difference in the trend before and after the global financial crisis. In line with this, we see smooth change on current account balance, net ODA, and trade balance throughout the period, except external debt which was highly fluctuating.

As we discussed above, Ethiopia has been experiencing high growth in the world economy which even continued during the global crisis. It is believed that the absence of drought and moderately favorable weather for agriculture during this time made it possible to grow (Priewe, 2016). Besides, the emergence of China in Ethiopia and additional foreign markets along with high government-led investment in infrastructure contributed immensely to the country’s development. As we can see from Figure 4, immediately after the crisis in 2009, Ethiopia is among the top five fastest-growing countries at the world level. Thus, the impact of the 2007/2008 global crisis has been debatable and controversial in Ethiopia (Paul, 2010), but it does not mean that the economy escaped the effect of the crisis (Asfaw, 2018; Assefa, 2019). The next section illustrates how the global financial crisis affected the economy and the monetary policy measures taken by the government.

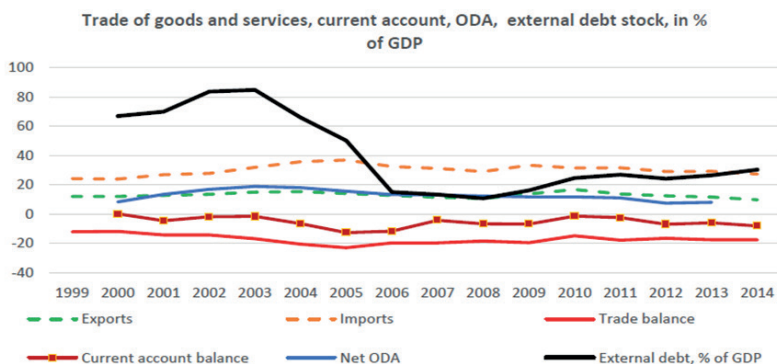


Figure 3. Trade, External Debt and Official Development Assistance (ODA). Source: National Bank of Ethiopia, Annual Report (2014/2015)



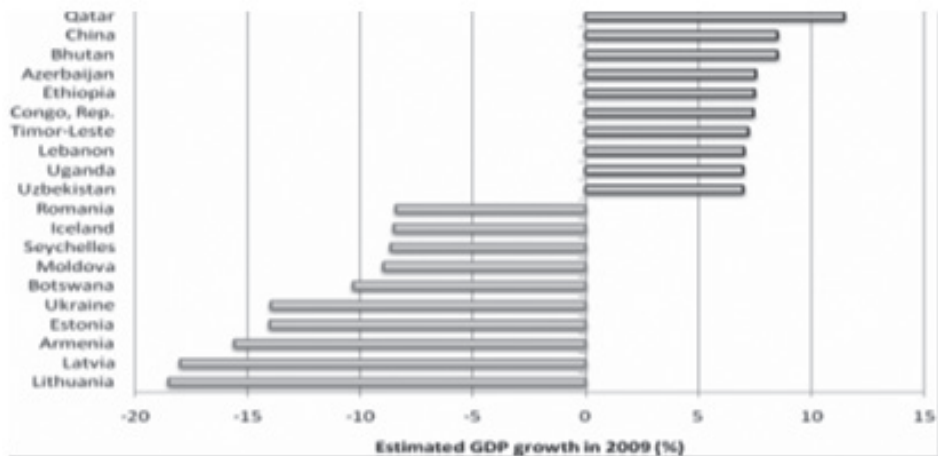


Figure 4. The fastest growing and contracting countries in 2009. Source: IMF World Economic Database (October 2009)

## The Consequences of Global financial crisis 2007/2008

### *The Economic Consequences of the crisis*

The financial crisis that simultaneously affected most of world financial markets turned out to be an economic crisis in many countries (OECD, 2009; Pop, 2009; Griffith-Jones, 2016). Its effect mainly erupted as a world economic crisis in September 2008 and the economic activities in developed and developing countries alike fell awfully in the final quarter of 2008 (Paul, 2010). First, the USA economy was directly hit by the meltdown in the sub-prime mortgage sector and its repercussion of the financial crisis. Consequently, the economy of the USA, along with other developed countries that are financially integrated, fell into recession in December 2007. It was estimated to have shrunk by 2.7% in 2009, which was, however, smaller than most G20 countries and the average of advanced economies' (-3%) contraction (Verick and Islam, 2010). In 2009, it was widely spread to different economic sectors including construction and car manufacturing sectors (Pop, 2009). But China, Australia, and India had minimized the major contraction despite their global integration. As we saw in Figure 4, above, some of the low-income countries such as Uganda and Ethiopia also managed to continue their fast growth despite the downturn (Verick, and Islam, 2010). However, the decline in the demand for exports from least developed countries, including Africa, and remittances & transfers were observed (Paul, 2010; Griffith-Jones, 2016).

In fact, the effect of the crisis on less developed countries has not been reached at a consensus, but it is obvious that they are highly exposed to a plethora of banking, currency fluctuation, external debt, and inflationary issues (Verick and Islam, 2010). As compared to other regions, the effect of the global economic crisis in Africa was very less (Paul, 2010). The African Development Bank report (2009) associates this

less margin effect of crisis with the limited financial market integration between Africa and developed countries, Africa's low share of total capital flows, and less number of African countries' leveraging funds on international financial markets (Paul, 2010). Also, the study shows that those middle-income countries, especially in Eastern and Central Europe and the Commonwealth independent states were the most severely affected by the crisis. Those countries which are shrunk by the highest margin include Lithuania, Armenia, Latvia, Ukraine, and Estonia, which experienced a 14% or more decline in GDP of 2009 (Verick and Islam, 2010).

Specifically, coming to the Ethiopian case, the direct impact of the crisis would not be significant mainly because of two reasons: First, the financial sector is not integrated with the global financial ecosystem, and no foreign banks are operating in the country still now. Second, in the financial sector activities of the country, mortgage borrowing does not have a significant effect on the national economy, and it was not directly affected by the "Sub-Prime Mortgage" crisis (Paul, 2010). Nevertheless, we cannot say that the country is free from the effect of the global financial crisis as a big chunk of money in one or another way come from developed countries those desperately affected by the crisis (Paul, 2010; Verick and Islam, 2010; Asfaw, 2018; Assefa, 2019).

The study also shows that the effects of the crisis were highly being felt by the country's economy from Oct. 2008 onwards. Especially, quarter II of 2008/09, when there was a 22.8% decline in total exports, seemed to be the greatest hit of the crisis compared with a quarter I of the same fiscal year (Paul, 2010).

### ***The Consequences of the Crisis in the Labor market***

The effect of the financial crisis of 2007/2008 is, in fact, multidimensional. The unemployment rate, in OECD countries alone, had increased from 5.7% in the 3<sup>rd</sup> quarter of 2007 to 8.6% in the 3<sup>rd</sup> quarter of 2009, showing about 10.1 million work-

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ers without jobs. According to the ILO's report (2010), at the global level, the size of unemployed individuals was estimated to be 212 million as of 2009; indicating a raise of the number by almost 34 million in 2007(ILO, 2010). On the contrary, countries such as Germany, Austria, and the Netherlands managed to avoid major devastation in the labor market despite a greater fall in their outputs. In the USA, unemployment has risen far more than in other countries and the same story is true with Denmark, Slovakia, Spain, and Turkey. As we discussed above, the countries severely suffered from both fall in output and deterioration in the labor market are Estonia, Ireland, Lithuania, and Latvia. The effect of the crisis on the Hungarian labor market is medium but it has faced severe economic contraction from 2.2 to negative 6.3% (Paul, 2010; ILO, 2010). Regarding Ethiopia, as GDP was growing during the crisis, both economic contraction and labor market shock are not significantly felt or not easy to single out. Generally, there are four major risks that African Countries, including Ethiopia, faced during the financial crisis: fiscal risk, capital outflow risk, export risk, and liquidity risk (African Development Bank, 2009; Paul, 2010; Griffith-Jones, 2016).

In nutshell, there are four gateways via which the impact of the global financial crisis has spread into Ethiopia and other African countries: FDI (capital outflow risk), remittances, Trade (export risk), and Foreign aid (Getnet Alemu, 2010; African Development Bank, 2009; Paul, 2010; Megersa, & Cassimon, 2015; Griffith-Jones, 2016). Despite the Ethiopian government estimation of 11.2% real GDP growth in 2008/09, according to IMF and WBG, overall growth was anticipated to have been as low as 7.5% (IMF, 2009) and 6% (World Bank, 2009; Getnet Alemu, 2010), respectively.

### ***Foreign Direct Investment (FDI)***

The amount of the capital investment in June 2008 was 61,333.2\$ million while it declined to only 28,510.3 million in Dec. 2008 (-53.5% -shrinkage). Especially, the crisis has immensely affected Ethiopia's investment environment. As of March 2008, about 2100 investment projects were approved, while about 1966 were applied in December of the same year (Paul, 2010). On an annual basis, foreign investment capital in terms of newly approved projects increased by 82.1% in the pre-crisis period but decreased by 20.7% in 2008/09 (Lulit, Emezat, and Zelalem, 2011). It is because the major sources of Ethiopian FDI such as Germany, the US, France, and the UK have been strongly hit by the crisis. Also, due to the liquidity shortfall in banks, investors from these countries are forced to reduce FDI inflows to Ethiopia (World Bank, 2009). As we can see from Figure 5, below, FDI sharply decreased from the second quarter of 2008 up to the first quarter of 2009. For instance, the US approved FDI worth \$428.2 million in 2008 but declined to \$166.6 million in 2009. UK-approved FDI declined from \$417 million to \$42.1 million, whereas FDI from Germany declined from \$613 million to \$66.8 million (-89.1%) in the same years. This simply shows that FDI in Ethiopia was significantly affected and sharply decreased due to the crisis in developed countries, especially until the second quarter

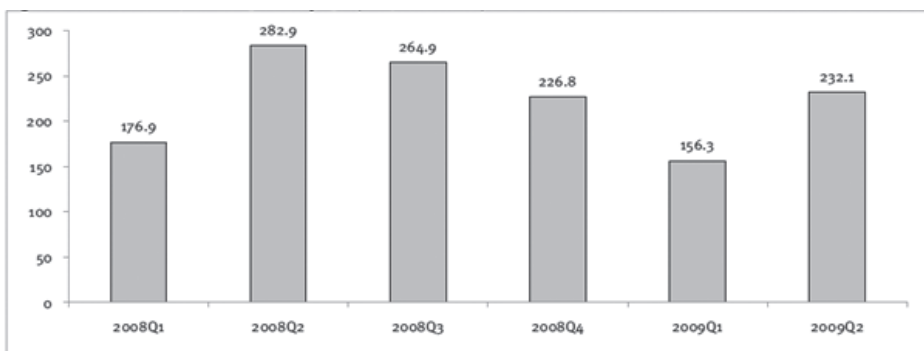
of 2009 (see also Figure 5., below) (National Bank of Ethiopia, 2010; Lulit, Emezat, and Zelalem, 2011).

### **Foreign Trade**

The export earnings in Ethiopia faced a slowdown because of the slides in world market demand coupled with domestic reasons (Lulit, Emezat, and Zelalem, 2011). The impact of the crisis was realized in the Ethiopian export both in terms of volume and unit values especially at the end of the 2007/08 fiscal year (Lulit, Emezat, and Zelalem, 2011; Paul, 2010; Assefa, 2019). The intensity of trade, both export, and import, relative to GDP shows the degree of integration or openness of the economy with the rest of the world. In the Ethiopian case, we see a consistent increase in the openness of the economy, from 35.7% as of 2000/01 to 50.6% as of 2004/05 and 50.4% in 2005/06. Then it started to slope down to the record of 39.4% in 2008/09. It seems that even more than the effect on FDI, the external shocks of the crisis was mainly felt in exports. The values of exports decreased from 23.7% as of 2007/2008 to -1.2% as of 2008/2009, whereas those of imports from 32.8% to 12.8 percent in the same period. Because of the loss of market demand in the major destination countries that were weakened by the recession, the Ethiopian export and import trade were significantly affected (World Bank, 2009; Getnet Alemu, 2010; Paul, 2010). Assefa (2019), specifically, argues that because of the decline in the demand for coffee in destination countries, the effect was felt in coffee exporting villages and significant school dropout was observed in those villages.

### **Remittance**

Generally, remittance is believed to be less pro-cyclical, less volatile, and less likely subject to barriers of politics. Hence, it's regarded as a more predictable means of getting foreign exchange for low-income economies than any other capital flows (Getnet Alemu, 2010; Megersa, & Cassimon, 2015). The remittance from Ethiopians living abroad is regarded as the main source of foreign exchange and a crucial



^ Figure 5. The flow of FDI in Ethiopia during the global crisis. Source, National Bank of Ethiopia (2009)

means of income that improves the living conditions of receiving households (Getnet Alemu, 2010). In 2007/2008, it reached about \$1 billion. The money flow from Ethiopian Diaspora was affected by the recession that resulted in the loss of jobs in the West. However, it is not an easy-going thing to accurately estimate the impact of the global recession on Diasporas remittance.

For instance, even a 30% reduction in remittance would mean a \$300 million loss to the country's economy, which is equivalent to the loss of foreign exchange income from coffee export (Paul, 2010; Megersa, & Cassimon, 2015). It can be in the form of official cash, in-kind, underground, or informal channels (Getnet Alemu, 2010). The crisis resulted in a 9.6% decrease in cash transfers from private individuals. Cash transfers increased again in 2009/10 (8.2%) but at a level lower than their pre-crisis level (Lulit, Emezat, and Zelalem, 2011). On average, the inflow from remittances declined by 6.5% between January and June 2009. As we see from Figure 6., below, the monthly remittance inflows, especially after September 2008, have been drastically decreased and continued up to negative 10 as of April 2009. This was happened due to a global crisis in developed countries that put pressure on the labor market and forced Diasporas to lay off (Getnet Alemu, 2010).

### Foreign Aid

The least developed countries including Sub-Sahara African countries are highly dependent on aid from developed countries (Paul, 2010; Griffith-Jones, 2016; Ngowi, 2010). The development initiatives of Ethiopia are beyond domestic capacity because of the high-level import intensity, insignificant levels of domestic savings, limited capacity to produce capital goods, and to secure enough foreign exchange (Getnet Alemu, 2010). Ethiopia highly relies on various bilateral and multilateral donors to finance many of its development programs and aid is an important source of deficit financing (Getnet Alemu, 2010) and a means of financing capital expenditure (30 to 40%) (Lulit, Emezat, and Zelalem, 2011). Despite a decline in the second quarter of 2008, in the second quarter of 2009, aid showed up to be increased. According

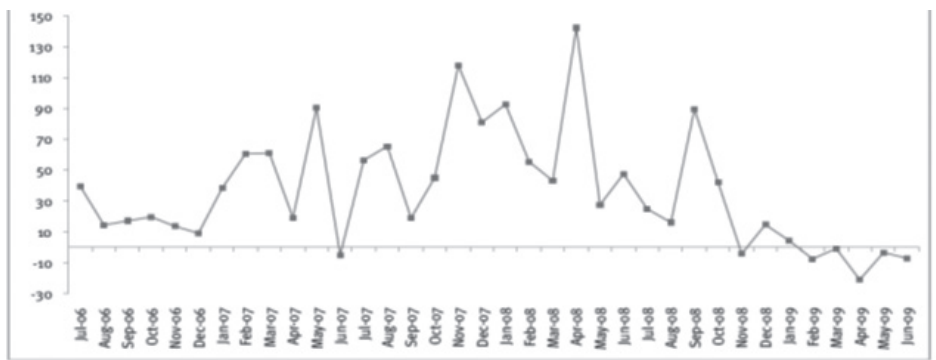


Figure 6. Remittance Flow to Ethiopia during the Financial Crisis. Source: National Bank of Ethiopia, 2010

to a National Bank report, the government of Ethiopia managed to get a significant increase of aid from the World Bank via the International Development Association (IDA) in the 2<sup>nd</sup> quarter of 2009. The official transfers increased (almost doubled) from \$281,256 million to \$513,228 million in the 2008/2009 1<sup>st</sup> and 2<sup>nd</sup> quarters. This is because the IMF provides budgetary support to all developing countries to withstand the financial crisis (Paul, 2010). Also, Ethiopia obtains the biggest proportion of aid from multilateral organizations such as the European Union, African Development Bank, the World Bank, IMF, and individual countries such as the U.S. and UK (Lulit, Emezat, and Zelalem, 2011). In general, as we have also seen in Figure 3., above, it seems that aid inflows have not been severely affected by the crisis as the result of donors' commitment to the prior aid agreement and the country's long lasted diplomatic relationship (Paul, 2010; Lulit, Emezat, and Zelalem, 2011).

### **The Monetary Policy Measures Taken by Government on Global Financial Crisis**

#### *Monetary policy response*

The pressure of inflation and the adverse effect of the external shocks had forced the National Bank of Ethiopia (NBE) to reassess its policy stands from monetary easing to monetary tightening since July 2007. Accordingly, it elevated both the minimum level of deposit interest rate and reserve and liquidity requirements and instituted credit restrictions (National Bank of Ethiopia, 2009). Temporarily, until removing inflationary pressure, the NBE had set a ceiling on the loan amount it would provide. In July 2007, the minimum rate of deposit interest was raised from 3 percent to 4 percent; the reserve and liquidity requirements of banks were increased from 5% to 10% in the same period. This liquidity and reserve requirements of banks were scaled up further to 15% in April 2008 to halt domestic credit expansion and greater scale monetary growth. NBE intended to keep broad money growth below 20 percent in the 2008/09 budget year by diluting private sector credit offered to low priority areas (National Bank of Ethiopia, 2009).

In the case of Ethiopia, using the interest rate as an inflation mitigating measure was less effective because of underdeveloped financial markets. Instead, they use of direct instruments of monetary policy such as controls on credit expansion could be the optimal policy response. As a short-term solution, significantly cutting back government borrowing from the banking system, specifically, was an optimal strategy in fiscal deficit reduction as well as alleviating inflationary pressure and combating the worsening external position (Getnet Alemu, 2010). The administrative measures such as a government-subsidized wheat import and distribution program coupled with the monetary policy response, indeed, worked very well to shun the inflationary tendency. Headline inflation, which raised from 15.8percent in June 2007 to 46.1% in Feb. 2009, drastically, declined to 18.7% in Sept.2009 (National Bank of Ethiopia, 2009).

### ***Banking and Financial policy response***

To alleviate the adverse effect of the crisis, the country's government also strengthened the regulation of banking, microfinance, and insurance institutions by modifying proclamation inculcating the emerging circumstances in the local and external environment. The commercial banks were alerted to give proper attention to managing credit risk and reducing default loans to below 5% by making proper follow-up on overdraft facilities. Besides, the NBE urged banks to be serious in lending activities, to make sure the quality of credit and not to take excessive risks. Also, the NBE took action to reduce the exposure of local banks to the international financial market by collecting and transferring maturing funds available in the banks to central banks such as the Bank of England, Federal Reserve, and Deutsche Bundesbank (Getnet Alemu, 2010; National Bank of Ethiopia, 2009).

### ***Fiscal Policy Response***

From the fiscal policy point of view, the response taken was to accelerate the collection of revenue and reduction of expenditure in lower priority areas. This had to be attained without compromising the need to elevate spending on critical poverty-oriented sectors, like agriculture. Accordingly, the government made a decision not to borrow from the domestic banking system on a net basis in 2008/09 (as a result domestic borrowing was only 2.7percent of GDP in 2007/08). To increase revenue, the installed base of the VAT system is expanded to incorporate more traders and sectors, such as restaurants, cafes, etc. This indeed resulted in a 31.5 percent rise in revenue from VAT, from Birr 2.15 billion in 2007/2008 to Birr 2.83 billion (approx. 92,908,730.20\$) in 2008/2009 (Getnet Alemu, 2010; National Bank of Ethiopia, 2009). The Ethiopian labor market policy responses to the crisis revolve around four main areas: improving the gap between supply and demand of the market, increasing and maintaining labor demand, targeting vulnerable groups, and providing income support (Verick and Islam, 2010).

### **Conclusion**

Monetary Policy is a driving engine on the hands of governments to steer their up financial markets, in particular, and economic growth in general. Financial markets refer to any marketplace where the trading of securities occurs, including the stock market, bond market, forex market, and derivatives market, among others. Due to a lack of direct integration with the world financial market, the Ethiopian economic growth rate was not severely affected by the financial crisis as compared to other developed and developing countries. And the country was even one of the top five fastest-growing economies during the crisis. The Ethiopian national savings and gross investment were continuously on the rise starting from 2007 until 2014 and no significant unique effect from the financial crisis was observed as compared to the pre-crisis period. This could essentially be associated with the rise of domestic government-led investment in infrastructure and strategic alliance partnership deals with China. However, due to the crisis in developed countries, FDI and remittance



flow was continuously sliding down until the second quarter of 2009. As the result of the loss of market demand in the major destination countries, the Ethiopian international trade, especially export value was seriously hit and shrunk from 23.7% in 2007/08 to -1.2% in 2008/09.

In contrast, the foreign aid or ODA was not affected, even increasing due to the provision of funds from UN organizations like IMF and World Bank. To shun or minimize the possible inflationary effect, the government increased the minimum deposit interest rate, reserve, and liquidity requirements, and reinstated the credit restrictions. The alert was given to commercial banks to give proper attention in managing credit risk and reducing non-performing loans to below 5% by making proper follow-up on overdraft facilities. Also, to withstand the crisis, the government effectively worked on increasing revenue from VAT and implemented a subsidized wheat import and distribution program. Moreover, the main reasons for the continued growth of the country amid crisis were the desynchronization of the country's financial market with the international financial market, an insignificant share of mortgage loans in domestic financial sector services, and high-level government-led infrastructure investment coupled with China's economic alliance. Therefore, the effectiveness of the above short-run measures does not justify the flawlessness of the monetary policy and its perpetuity for all time.

### **Implications and Ways forward**

The Ethiopian government's measure that increased the minimum deposit interest rate worked well, at least for the short-run, to curb inflationary pressure as banks absorb money from the market through it. However, it decreases domestic investment and export as well because it could encourage investors to prefer to make more money simply by depositing it in the banks rather than engaging in economic activities or international trade. That is why we see the slipping of the exports in the reports during the crisis. Rather, increasing reserve rate and liquidity requirements along with other credit restrictions seems to have been good. The increased gross investment, especially public investment, has contributed to the continual growth of the economy coupled with the strategic alliance with China that has accelerated the country's capital inflows during the crisis. However, the intensive government-led investment could lead to high-scale corruption and inefficiency. It has been well observed in Ethiopia that big public investment projects such as sugar factories, cement factories, industrial parks, and Ethiopian grand renaissance hydroelectric dam (GERD) have been exposed to embezzlement and excessive delay of completion. In this regard, a public-private partnership-based investment could be the ideal pathway for a developmental state like Ethiopia.

On the other side, the Ethiopian government's decision to keep away the country's financial market from the international market helps the economy by reducing vulnerability to external shocks like the financial crisis of 2007/2008. But it has also made the domestic financial market weak and remains as an infant. The country misses millions of dollars that could be obtained in the form of taxes, commissions,

dividends, stock market, and foreign exchange traders' profit from the internationally integrated or synchronized financial and capital markets. Millions of online jobs could be created for the educated unemployed youths, the acute shortage of foreign currency could be minimized, and companies could publicly trade their shares if the forex market, stock markets, and other markets were open and financial market synchronization was pursued. It is possible to integrate with the international financial market and to remain unaffected or minimize the effect of shocks. For instance, India, one of the highly integrated capital markets, managed the crisis by initiating stimulus packages in the form of tax relief to boost demand and increased expenditure on public projects to create employment; Australia, which was one of the least affected, mostly applies short-term (up to three months) mortgage loans, a strong banking system that limits competition for corporate control and uses prudential supervision (Eslake, 2009). It was aggressive competitiveness among USA banks in giving mortgage loans to even clients with low credit rates that have fueled the subprime crises. And China immediately applied a strong fiscal stimulus package during 2007/2008 (Linyue Li et al.'2012) and well managed the effect of the crisis.

Moreover, the housing problem is one of the prime issues in which hundreds of thousands of citizens save their money for decades through the government's house construction development office but at the end of the day, they don't get their houses. This problem is mainly related to the lack of a mortgage loan facility and its accessibility, which could be resolved if there are specialized mortgage banks and professional investment agents could step into the market. In nutshell, countries like Ethiopia should not fear making all the necessary arrangements to integrate their financial markets with foreign stock exchange markets, banks, investment institutions, and brokers.

Even though the study sheds more light on the global financial crisis and offers amicable insights on the Ethiopian economy, in particular on its monetary policy, it is not free from limitations. The study is only limited to secondary sources of data and it could be more resounding if supported by primary data from the financial sector. Following the financial crisis, the world has experienced another global phenomenon, Covid19. However, any study that considers the two phenomena should notice the following points: first, the cause for the financial crisis is quite different from Covid-19; second, the consequences of the two crises could be similar, if not in terms of depth, when it comes to effects on the labor market, international trade, and inflation and other economic spectrum but the latter one seems not to have a devastating effect on financial markets. The respective effect of the two crises and the corresponding monetary policy responses of different countries could be another future research topic. ☀

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