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From Peg to Float: Economic and Political Implications of the Ethiopian Birr Flotation

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Abstract: The adoption of a floating exchange rate system constitutes a pivotal economic policy decision that both reflects and influences a nation's broader political economy. The flotation of the Ethiopian Birr (ETB) marks a substantial shift in Ethiopia's monetary policy framework, carrying significant implications for the country's macroeconomic stability and development trajectory. This paper investigates the rationale behind the policy shift, its anticipated economic impacts, and potential future pathways for Ethiopia. Through a systematic review of the literature and comparative analysis of case studies from other countries, the study provides a comprehensive evaluation of the benefits, risks, and strategic considerations associated with the move to a floating exchange rate. While the reform offers promising prospects for greater economic autonomy, enhanced trade competitiveness, and market-driven growth, it also introduces considerable challenges, including inflationary pressures, socioeconomic inequality, and political uncertainty. To fully leverage the potential of this transition, Ethiopia must prioritize sound policy management, institutional strengthening, and structural economic reforms. These measures are critical to mitigating the inherent risks of exchange rate liberalization and to ensuring that the country achieves long-term macroeconomic stability, inclusive growth, and sustained structural transformation.

Keywords: Floating Exchange Rate, Ethiopian Birr, Currency Flotation, Inflation, Monetary Policy, Trade Balance, Political Economy, Sub-Saharan Africa, Institutional Reform, Economic Transition

1. Introduction

Exchange rate policy represents a fundamental pillar of macroeconomic management, shaping trade balances, inflation trajectories, and national economic sovereignty (Krugman & Obstfeld, 2021). The choice of an exchange rate regime is inherently political, as different systems offer varying degrees of control, stability, and exposure to external forces. While fixed exchange rate regimes provide predictability and nominal stability, floating exchange rate systems afford greater flexibility and responsiveness to changing global market dynamics.

Under a floating exchange rate regime, the value of a country's currency is determined by market forces, primarily supply and demand, rather than being pegged to another currency or basket of currencies. Unlike managed or fixed systems that require central bank intervention to maintain a predetermined rate, floating regimes allow currencies to fluctuate freely. This system offers key advantages such as enhanced policy autonomy, enabling governments to focus on domestic macroeconomic objectives. However, it also introduces risks, notably increased exchange rate volatility, which can create uncertainty for both businesses and consumers (Mankiw, 2021b; IMF, 2023d; World Bank, 2022a).

Floating exchange rates are often viewed as a means of reclaiming economic sovereignty. Freed from the constraints of defending a fixed rate, countries can tailor their monetary policies to domestic needs, such as controlling inflation or stimulating growth (Rodrik, 2008b). For instance, following Brexit, the United Kingdom adopted a more flexible exchange rate stance to manage economic uncertainty and recalibrate trade relationships (World Bank, 2022g). Similarly, floating exchange rates can enhance trade competitiveness by enabling currency devaluation, making exports more affordable and imports more expensive. Nonetheless, such benefits can trigger political opposition, particularly in countries heavily reliant on imports. Japan's experience with yen depreciation during Abenomics in the early 2010s sparked both economic gains and international criticism for perceived currency manipulation (Krugman & Obstfeld, 2021; Reinhart & Rogoff, 2009).

In developing economies, floating exchange rates often generate inflationary pressures due to the rising costs of imports, eroding household purchasing power and potentially provoking political unrest. Argentina's transition to a floating exchange rate in the early 2000s, for example, led to hyperinflation, widespread social discontent, and political instability (Rodrik, 2008b; IMF, 2023a). The

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effectiveness of a floating exchange rate regime thus hinges on the credibility and independence of monetary institutions. When political interference undermines market confidence, as was the case in Zimbabwe during the late 2000s, currency collapse can follow, underscoring the vital role of institutional integrity (Reinhart & Rogoff, 2009; World Bank, 2022i).

Floating regimes also align economies more closely with global financial markets, exposing them to international investment trends and speculative pressures. While this integration can attract foreign direct investment and enhance capital flows, it also renders economies vulnerable to external shocks. The 1997 Asian Financial Crisis starkly illustrated how speculative attacks on floating currencies can destabilize entire regions and alter political landscapes (Rodrik, 2008b; IMF, 2023c).

Despite these challenges, floating exchange rates present valuable opportunities. They offer economic agility, allowing countries to adjust to global disruptions and evolving trade conditions (World Bank, 2022h). Transparent, market-driven currency valuation can also increase investor confidence, stimulate economic growth, and promote integration into global markets (IMF, 2023). Furthermore, the demands of managing a floating exchange rate system can catalyze institutional strengthening by necessitating robust central banks and sound monetary policy frameworks (Rodrik, 2008b).

Theoretical insights reveal that in advanced economies with mature financial markets, floating exchange rates tend to be relatively stable. These systems allow for monetary independence and act as automatic stabilizers against external shocks as exemplified by the United States and the Eurozone (Mankiw, 2021b; Obstfeld & Rogoff, 1996). However, in developing countries, structural challenges such as shallow financial systems, dependency on commodity exports, and weak institutions exacerbate exchange rate volatility and limit the benefits of currency flexibility (Rodrik, 2008a; Reinhart & Rogoff, 2009; IMF, 2023g).

This study investigates Ethiopia's recent decision to float the Ethiopian Birr (ETB), assesses its economic consequences, and explores potential future trajectories. It seeks to answer key questions concerning the implications of the currency's flotation and offers strategic insights into policy options and economic reform pathways.

The contributions of this paper are twofold. First, it provides a comprehensive assessment of the economic implications of Birr's flotation, drawing upon a synthesis of both foundational theories and emerging empirical research. Second, it proposes an interconnected research agenda designed to inspire future inquiry into the mechanisms, risks, and developmental outcomes associated with exchange rate reforms in developing economies. In doing so, this study positions itself as a resource for scholars, policymakers, and stakeholders navigating the complex terrain of monetary policy in transitional economies.

2. Theoretical and Conceptual Framework

The transition to a floating exchange rate in Ethiopia is best understood through a multidisciplinary lens that combines economic, institutional, and political economy theories. At its core, the shift reflects a move toward market-determined currency valuation, granting the central bank greater monetary policy autonomy as described in the Mundell-Fleming model(Krugman & Obstfeld, 2021). Simultaneously, the floating exchange rate influences inflation, trade competitiveness, and investment flows, as captured by theories such as Purchasing Power Parity (PPP), Export-Led Growth, and the Balassa-Samuelson hypothesis(Mankiw, 2021b; Rodrik, 2008b).

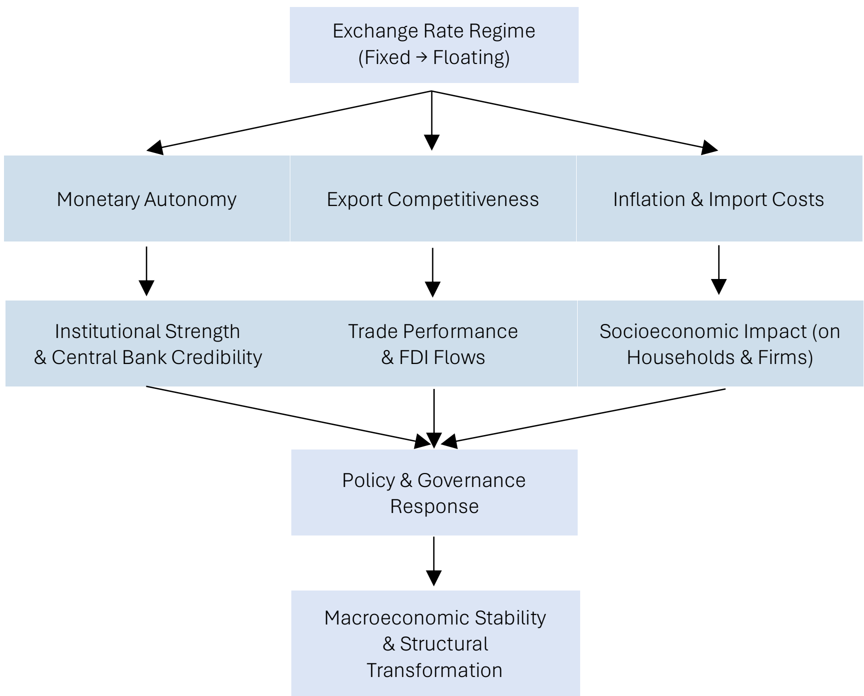

Figure 1: Conceptual Framework: Implications of a Floating Exchange Rate in Ethiopia

Yet, the macroeconomic effects of floating exchange rates are not purely mechanical. Political economy perspectives highlight how institutional strength, policy coherence, and public trust mediate the outcomes of exchange rate liberalization. In developing economies like Ethiopia, where governance institutions are still consolidating and import dependency is high, the risks of inflationary shocks and social unrest are significant. These risks necessitate a coordinated and inclusive policy response.

To structure the analysis, this study presents a conceptual framework (Figure 1) that maps the causal linkages between the exchange rate regime shift and its downstream effects on monetary autonomy, trade, inflation, institutional strength, and social outcomes. The model also emphasizes the central role of policy responses in determining whether the transition results in macroeconomic instability or long-term structural transformation.

3. Materials and Methods

This study adopts a systematic literature review approach to investigate the economic implications of floating exchange rate regimes, with a specific focus on the Ethiopian Birr (ETB). The objective is to critically examine the motivations behind the flotation of the Birr, assess its macroeconomic consequences, and identify viable pathways for future policy formulation. To achieve this, the review synthesizes both theoretical perspectives and empirical findings from relevant case studies within Sub-Saharan Africa and comparable developing economies.

Data were sourced from a wide range of academic and institutional publications. A comprehensive search strategy was employed to identify studies from major academic databases including Scopus, JSTOR, EconLit, Web of Science, and Google Scholar. These were complemented by grey literature retrieved from credible institutions such as the International Monetary Fund (IMF), the World Bank, the African Development Bank (AfDB), and the Ethiopian Economics Association (EEA). The search was restricted to publications available up to December 31, 2024. To ensure thematic and contextual relevance, a combination of keywords was applied, including but not limited to: "floating exchange rate", "currency flotation", "Ethiopian Birr", "macroeconomic reform", "trade competitiveness", and "exchange rate volatility".

The selection of literature was guided by well-defined inclusion and exclusion criteria. Studies were included if they provided a focused analysis of floating or managed exchange rate regimes, with particular attention to macroeconomic outcomes such as inflation, investment, trade, and monetary policy. Additional emphasis was placed on works discussing Ethiopia or similarly situated developing countries. Eligible publications comprised peer-reviewed journal articles, institutional reports, policy briefs, and working papers. To avoid linguistic bias and acknowledge Ethiopia's geographic and geopolitical context, the review also incorporated sources published in English, Amharic, Arabic, and French. Studies lacking methodological rigor, theoretical grounding, or empirical application to relevant economies were excluded from the analysis.

The literature screening process followed the Preferred Reporting Items for Systematic Reviews and Meta-Analyses (PRISMA) guidelines. An initial pool of 87 studies was identified through database searches and manual screening. After evaluating titles, abstracts, and full texts, a total of 45 studies met the inclusion criteria and were retained for synthesis. The selected studies were then subjected to thematic analysis, through which recurring concepts and analytical categories were identified. The analysis focused on key dimensions such as inflationary effects, exchange rate pass-through, institutional responses, trade performance, capital flows, and the socio-political implications of exchange rate reform.

Particular attention was paid to the integration of grey literature, recognizing the value of policy documents, government reports, and non-peer-reviewed sources that often contain practical insights and real-time data not readily available in academic publications. Given the risk of publication bias, efforts were made to include diverse viewpoints and underrepresented findings, particularly those that offered critical reflections on the potential limitations or unintended consequences of currency flotation. Language accessibility and regional dispersion were also considered, particularly in the context of Sub-Saharan Africa, to ensure a more inclusive and representative synthesis.

Although the systematic review methodology provides a robust framework for exploring the research questions, certain limitations must be acknowledged. First, the reliance on secondary data restricts the ability to generate new empirical evidence, and the findings are therefore dependent on the quality and scope of the existing literature. Second, publication bias remains a potential concern, as studies with statistically significant or policy-aligned results are more likely to be published than those with neutral or negative findings. Furthermore, language barriers and limited access to region-specific institutional archives may have inadvertently excluded some valuable sources.

The chosen methodology is aligned with the study's overarching goal of producing an evidence-based and contextually grounded assessment of Ethiopia's transition to a floating exchange rate system. By synthesizing a diverse body of literature, this review not only contributes to a deeper understanding of the economic and institutional implications of currency flotation but also offers a foundation for future empirical studies and policy development. The methodologically rigorous and multidisciplinary nature of this approach ensures that the analysis remains both comprehensive and policy-relevant, bridging the gap between academic inquiry and practical application.

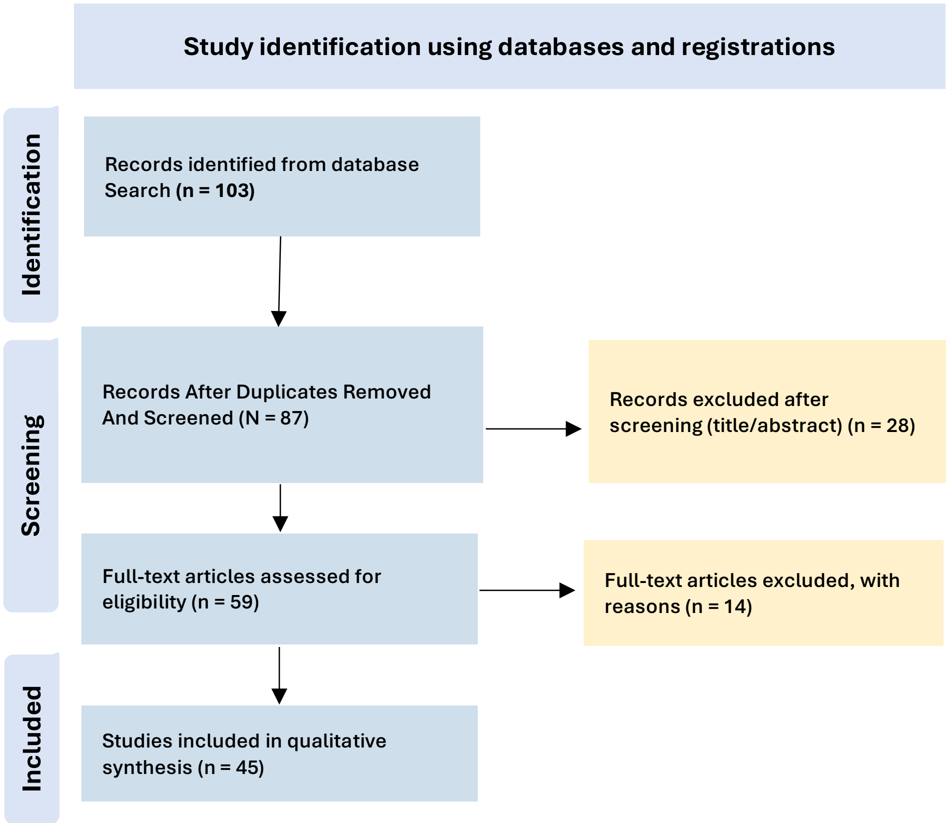

Figure 2: PRISMA Flow Diagram of Study Selection

4. Ethiopian Birr Flotation Policy and Its Implications for Economic Growth and Structural Transformation

The transition to a floating exchange rate in Ethiopia was driven by a confluence of structural and macroeconomic factors. One of the primary drivers was the persistent scarcity of foreign exchange, which significantly hindered the country's ability to finance imports and support investment (World Bank, 2022c). Additionally, the rapid expansion of the black market for foreign currency highlighted the inefficiencies and distortions inherent in the previously managed exchange rate regime (IMF, 2023d). Furthermore, mounting macroeconomic imbalances characterized by escalating inflation, growing fiscal deficits, and declining foreign reserves necessitated a comprehensive policy shift to address these entrenched economic challenges (African Development Bank, 2023).

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In light of these pressures, Ethiopia's decision to float the Birr has triggered extensive debate among economists, policymakers, and development stakeholders. Traditionally, the Ethiopian currency operated under a managed exchange rate system, which provided a degree of stability in external trade and shielded the economy from abrupt external shocks. However, growing internal and external imbalances including unsustainable fiscal spending, falling reserve buffers, and widening currency differentials between official and black market rates necessitated a decisive shift in monetary policy direction.

4.1. Flotation of the Ethiopian Birr from EPRDF to Present

The exchange rate policy of the Ethiopian Birr has undergone significant transformation since the Ethiopian People's Revolutionary Democratic Front (EPRDF) assumed power in 1991. In the early years of the new administration, the Birr was pegged to the U.S. dollar in an effort to stabilize the economy following prolonged political and economic upheaval. This fixed exchange rate regime was intended to anchor inflation expectations and restore external confidence. Over time, however, Ethiopia transitioned toward a more dynamic exchange rate framework, characterized by a series of deliberate devaluations aimed at stimulating export performance and correcting persistent trade imbalances.

During the 1990s, the government pursued a gradual devaluation strategy to enhance export competitiveness. The official exchange rate moved from 2.07 ETB per U.S. dollar in 1992 to approximately 8.60 ETB/USD by the end of the decade (World Bank, 2022c). In the early 2000s, Ethiopia adopted a managed floating exchange rate regime, whereby periodic devaluations were used to support its development strategy, particularly by promoting agricultural exports. This approach sought to maintain a relatively competitive exchange rate as a tool for advancing economic growth.

By the 2010s, however, the Ethiopian economy experienced mounting pressure stemming from rapid economic expansion, surging demand for foreign exchange, and deepening macroeconomic imbalances. In response, the National Bank of Ethiopia devalued the Birr by 15 percent in 2017, citing the need to counteract the growing influence of parallel currency markets and encourage export growth (IMF, 2020b). In the early 2020s, these challenges became more acute, with foreign reserves dwindling and trade deficits widening. In response, the central bank began to loosen its control over the exchange rate, marking a shift toward a more flexible regime. By 2023, the depreciation of the Birr had intensified considerably as the government attempted to address structural macroeconomic vulnerabilities through exchange rate liberalization (African Development Bank, 2023).

A. Why the Exchange Rate Matters for Structural Transformation and Growth in Ethiopia

The move toward a floating exchange rate reflects a strategic attempt to reorient Ethiopia's macroeconomic framework in support of long-term structural transformation. According to the World Bank (2023), Ethiopia's managed float system was increasingly unsustainable in the face of mounting inflation, persistent trade deficits, and chronic shortages of foreign currency. The report underscores the necessity of adopting a more flexible exchange rate regime as a means of promoting economic growth, improving external competitiveness, and enabling structural reform.

The flotation of the Ethiopian Birr presents a complex mix of immediate challenges and long-term opportunities. In the short run, exchange rate volatility can generate inflationary pressures, particularly by raising the cost of imported goods. This, in turn, may erode household purchasing power and lead to adverse social and economic consequences (Krugman & Obstfeld, 2021). Moreover, depreciation can increase the burden of external debt and provoke capital flight, as investors shift assets to more stable markets (Reinhart & Rogoff, 2009). Small businesses, especially those dependent on imported inputs, may struggle with rising operational costs, which could dampen productivity and overall economic activity (Mankiw, 2021b).

Nonetheless, the potential long-term benefits of a floating exchange rate are considerable. Allowing the Birr to adjust freely in response to market conditions may enhance trade competitiveness by making Ethiopian exports more affordable in global markets. Additionally, it grants the central bank greater autonomy in shaping monetary policy, enabling a more effective response to domestic economic fluctuations (Rodrik, 2008c; IMF, 2023b). If complemented by sound macroeconomic management and institutional reforms, a floating exchange rate could serve as a catalyst for structural transformation, reducing Ethiopia's dependence on commodity exports and fostering a more diversified, resilient economy (World Bank, 2022c). While short-term social costs are inevitable, a deeper exploration of inflationary effects and public sentiment would enrich understanding of the broader implications of this transition.

B. Exchange Rate Reform in Ethiopia

The Ethiopian Economics Association (2016) offers a useful historical perspective on the evolution of the country's exchange rate policy. Its report evaluates the shift from a managed floating system to a more flexible framework, outlining both the economic rationale for reform and the associated risks. The analysis highlights how a more liberal exchange rate could help correct external imbalances, but also acknowledges potential drawbacks such as inflationary surges and declining public confidence in monetary authorities. Although insightful, the report's lack of empirical modeling limits its analytical depth. A comparative framework involving similar transitions in other low- and middle-income countries would have added broader contextual relevance.

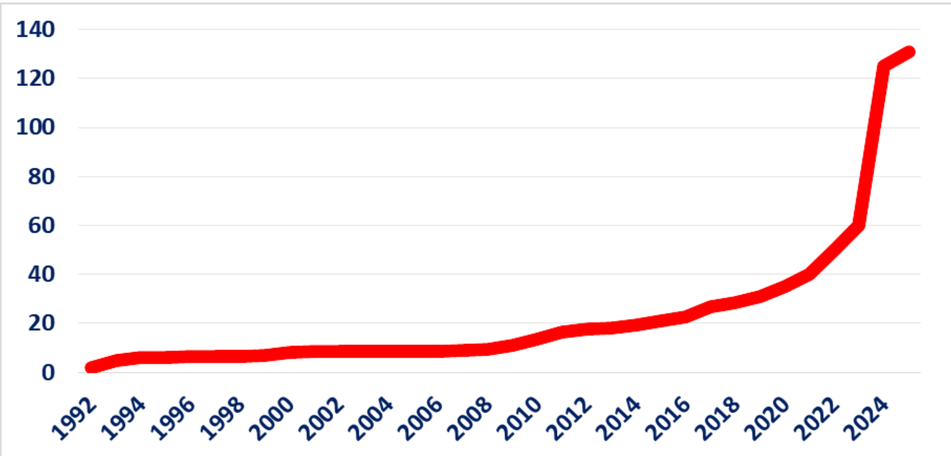

Figure 3: Ethiopian Birr to U.S. Dollar Exchange Rate (1992–2025). Source: Trading Economics, 2025

The historical trajectory of the Birr's depreciation illustrates the evolving nature of Ethiopia's exchange rate policy. Beginning at 2.07 ETB/USD in 1992 under a fixed regime, the currency depreciated to 8.60 ETB/USD by 1999 as part of market liberalization (World Bank, 2022c). The 2000s witnessed continued devaluation at a measured pace, with the rate reaching 13.50 ETB/USD by 2010, driven by a developmental strategy that emphasized export promotion (IMF, 2023). However, persistent structural weaknesses in the 2010s particularly rising inflation, a widening current account deficit, and shortages of foreign currency accelerated depreciation.

By 2017, the exchange rate had weakened to 27.00 ETB/USD, prompting a 15 percent devaluation aimed at restoring macroeconomic stability (African Development Bank, 2023).

In the 2020s, Ethiopia faced intensified pressures on its exchange rate, culminating in a dramatic depreciation to 60.00 ETB/USD in 2023. Following the move to a more flexible regime, the Birr continued to depreciate, reaching approximately 130.82 ETB/USD by early 2025 (Smith, 2024). This sharp devaluation carries wide-ranging implications. Inflationary pressures have intensified, increasing the cost of imports and contributing to financial instability. In light of these developments, the government must strengthen the capacity of monetary institutions, ensure greater fiscal discipline, and implement robust diversification strategies to mitigate the adverse effects of currency volatility and secure long-term economic sustainability.

C. Currency Shocks and Firm Behavior in Ethiopia and Uganda

Lopez and Tesfaye (2023) provide an empirical analysis of how currency fluctuations affect firm-level behavior in both Ethiopia and Uganda. Their study examines the microeconomic implications of exchange rate volatility, focusing on its influence on production costs, pricing strategies, and export competitiveness. By adopting a cross-country comparative framework, the research offers valuable insights into the specific challenges faced by Ethiopian firms within a broader regional context. The findings underscore the vulnerability of businesses to exchange rate shocks, particularly in import-dependent sectors, and illustrate how firms adapt their strategies in response to fluctuating currency values. While the study contributes meaningfully to the literature by offering firm-level evidence on the impacts of monetary policy shifts, it would benefit from a more nuanced sectoral analysis within Ethiopia. Such an extension would allow for a deeper understanding of the heterogeneous effects across industries and economic segments, particularly those that vary in their exposure to international trade and currency risk.

D. Ethiopia Floats Currency as It Seeks to Secure IMF Deal

Smith (2024), writing in *The Financial Times*, offers a journalistic perspective on Ethiopia’s decision to float the Birr as part of a broader package of economic reforms linked to negotiations with the International Monetary Fund (IMF). The article provides timely and accessible insights into the political economy surrounding the exchange rate reform, highlighting the role of international financial institutions in shaping domestic macroeconomic policies. It also contextualizes the flotation within global trends, drawing connections between Ethiopia’s policy shift and similar cases in other developing economies. However, while the article is informative and contextually rich, its reliance on descriptive reporting limits its analytical depth and academic utility. The absence of a rigorous theoretical or empirical framework makes it less suitable for long-term policy evaluation, though it remains a useful source for understanding the political motivations and international dimensions of the reform.

Taken together, these contributions offer a multifaceted view of Ethiopia’s exchange rate reform, integrating theoretical, empirical, and practical perspectives. They provide critical insights for economists, policymakers, and development practitioners seeking to understand the complex drivers and implications of the Birr’s flotation. Nevertheless, existing analyses would be strengthened by a more explicit integration of the social and political dimensions of exchange rate reform. In particular, there is a need to investigate how currency depreciation influences public confidence, economic governance, and social cohesion.

The flotation of the Ethiopian Birr carries profound socio-political consequences that extend beyond conventional macroeconomic indicators. Currency depreciation tends to affect different segments of society unequally, with low-income households bearing the brunt of rising import costs, inflation, and declining real wages (Mankiw, 2021b). These conditions can exacerbate existing inequalities and undermine the living standards of vulnerable populations. Moreover, employment patterns may shift as firms reliant on imported inputs face higher costs, potentially leading to job losses, wage stagnation, or reduced business competitiveness (IMF, 2023b). In this environment, financial inclusion becomes critically important. Institutions such as savings and credit cooperatives (SACCOs) and microfinance organizations can play a key role in buffering the most affected groups and promoting economic resilience at the grassroots level (World Bank, 2022c).

From a political standpoint, exchange rate reform—particularly one that triggers visible price increases can strain public confidence in government institutions. If inflation is not effectively managed, or if compensatory measures are perceived as inadequate, public dissatisfaction may manifest in the form of protests, political instability, or demands for policy reversals (Rodrik, 2008c). In such cases, transparent governance and credible economic communication become essential tools for maintaining public trust and ensuring the legitimacy of monetary reforms (Reinhart & Rogoff, 2009). Additionally, Ethiopia's geopolitical positioning may be shaped by how its currency reform is perceived by international financial institutions, development partners, and foreign investors (Krugman & Obstfeld, 2021). Their responses could influence capital flows, bilateral agreements, and Ethiopia’s broader role in regional economic cooperation.

To mitigate the adverse effects of currency flotation, the Ethiopian government must prioritize the implementation of robust and coordinated monetary and fiscal policies. Ensuring the independence of the central bank is critical for maintaining policy credibility and market confidence. Moreover, comprehensive social safety nets such as targeted subsidies, food security initiatives, and income support programs will be essential in protecting vulnerable populations during periods of adjustment (IMF, 2023b). The government must also foster inclusive dialogue with key stakeholders, including private sector actors, labor unions, and civil society organizations. Such engagement is vital for building a broad-based consensus around economic reforms and ensuring that the transition to a floating exchange rate system proceeds in an equitable and socially sustainable manner.

4.2. Lessons from Other Countries

Ethiopia's transition to a floating exchange rate can draw valuable insights from the experiences of other countries that have undergone similar monetary reforms. Egypt's flotation of the pound in 2016, for instance, serves as a notable example of how exchange rate liberalization can contribute to macroeconomic stabilization. The reform succeeded in boosting foreign reserves and attracting significant foreign direct investment. However, it also triggered substantial inflationary pressures, necessitating the implementation of tight monetary policies to control price instability and safeguard vulnerable populations (IMF, 2020a).

Nigeria's experience with the partial flotation of the naira highlights the importance of policy consistency and institutional resilience. While the reform aimed to improve currency valuation and investor confidence, its effectiveness was undermined by inconsistent implementation and weak regulatory institutions. These shortcomings limited the reform's long-term sustainability and exacerbated macroeconomic instability (World Bank, 2021). This case illustrates that without coherent policy execution and strong institutional backing, exchange rate reforms may produce only partial or temporary benefits.

Ghana provides a contrasting and more successful example. Following the adoption of a floating exchange rate regime, Ghana was able to maintain relative currency stability, largely due to prudent fiscal management and efforts to diversify its export base. The country's post-reform trajectory underscores the significance of reducing dependency on a narrow range of export commodities and maintaining fiscal discipline in ensuring the effectiveness of monetary reforms (African Development Bank, 2023).

These case studies offer Ethiopia a practical roadmap for managing the challenges and optimizing the opportunities associated with currency flotation. A recurring lesson across these examples is the critical importance of institutional strength, macroeconomic coordination, and export diversification. Floating exchange rate regimes, while offering enhanced flexibility, require careful calibration to avoid unintended consequences such as inflationary surges, capital flight, and prolonged uncertainty.

Moreover, the Ethiopian case must be understood not only in economic terms but also through its broader social and political dimensions. Currency depreciation tends to disproportionately affect lower-income groups, who bear the burden of rising import costs, inflation, and reductions in real income (Mankiw, 2021b). As businesses face higher operational costs due to increased prices of imported inputs, employment may become less secure, potentially resulting in job losses, wage stagnation, or reduced competitiveness (IMF, 2023b). In such a scenario, financial inclusion becomes essential. Institutions such as savings and credit cooperatives (SACCOs) and microfinance organizations can act as shock absorbers, offering critical support to those most affected (World Bank, 2022c).

From a political perspective, currency flotation presents significant risks if not managed transparently. Rising inflation and deteriorating living standards can quickly erode public confidence in government institutions, particularly in contexts where communication is lacking or social safety mechanisms are insufficient. As Rodrik (2008c) notes, such dissatisfaction can escalate into political unrest, policy reversals, or weakened governance legitimacy. Moreover, the international response to Ethiopia's reform particularly from financial institutions, investors, and trade partners will likely shape the country's geopolitical positioning and economic trajectory (Krugman & Obstfeld, 2021).

To enrich the policy dialogue and improve the applicability of lessons drawn from comparative experiences, Ethiopia would benefit from examining a broader set of African case studies. Nigeria's ongoing currency reform efforts since 2016, for instance, reflect both the positive potential of market liberalization and the inflationary risks of mismanaged transitions (IMF, 2023g). Ghana's trajectory reinforces the value of macroeconomic discipline, while South Africa's long-standing floating regime exemplifies how well-developed financial institutions and sound monetary policies can help stabilize exchange rate fluctuations and attract sustained investment flows (World Bank, 2022f; Mankiw, 2021b).

Together, these examples suggest that the success of a floating exchange rate system hinges not merely on adopting the policy itself, but on the broader macroeconomic environment, institutional capacity, and political commitment that surround its implementation. Flexibility and competitiveness are among the potential advantages, but they must be balanced against risks of excessive inflation, capital outflows, and socioeconomic distress.

In Ethiopia's case, the government must take a proactive approach to mitigate these risks by implementing sound monetary and fiscal policies, strengthening the independence and credibility of the central bank, and designing robust social protection mechanisms such as targeted subsidies and food security programs (IMF, 2023c). Moreover, inclusive dialogue with key stakeholders such as private sector actors, labor unions, and civil society will be essential for building trust and ensuring that the transition to a floating exchange rate is not only economically effective but also socially equitable and politically sustainable.

4.3. Empirical Trends: Exchange Rate Fluctuation and Macroeconomic Indicators in Ethiopia

Recent macroeconomic data further underscore the impact of Ethiopia's evolving exchange rate policy on key economic indicators. Between 1992 and 2025, the Ethiopian Birr experienced consistent depreciation, moving from 2.07 ETB/USD in 1992 to an estimated 130.82 ETB/USD by 2025(Trading Economics, 2025). This trend was accompanied by rising inflation, which reached an estimated 35.2 percent in 2025, highlighting the inflationary risks associated with a floating exchange rate regime. Concurrently, Ethiopia's trade balance remained persistently negative, reflecting structural import dependency and weak export diversification. Foreign direct investment (FDI), while initially increasing through the 2000s, declined post-2020, potentially reflecting reduced investor confidence amid heightened exchange rate volatility. Similarly, foreign exchange reserves declined sharply from $2.9 billion in 2017 to approximately $0.8 billion in 2025, raising concerns about external vulnerability and currency stability. These trends collectively illustrate the complex interplay between exchange rate liberalization and macroeconomic stability. They also reinforce the urgency of adopting complementary policies such as strengthening central bank independence, diversifying exports, and improving investor confidence to mitigate the risks of prolonged depreciation and inflationary pressures.

Table 1: *2025 values are estimates based on trend projections

Year	Exchange Rate (ETB/USD)	Inflation (%)	Trade Balance (% of GDP)	FDI (% of GDP)	FX Reserves (USD bn)
1992	2.07	21.6	-5.4	0.8	0.4
2000	8.54	6.2	-8.1	2.1	0.8
2010	13.50	8.1	-5.7	2.5	2.1
2017	27.00	11.0	-7.4	3.3	2.9
2023	60.00	28.3	-9.8	1.4	1.1
2025*	130.82	35.2 (est.)	-10.5 (est.)	1.0 (est.)	0.8 (est.)

Source: Calculated by the author

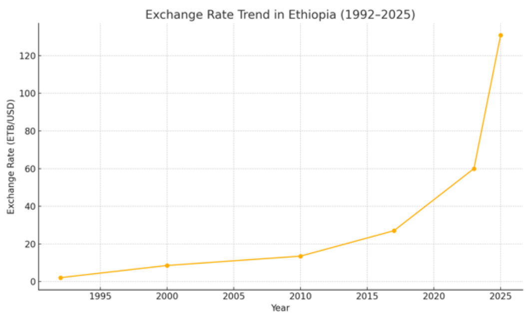

Figure 3: Exchange Rate Trend in Ethiopia (1992–2025)

This figure illustrates the progressive depreciation of the Ethiopian Birr against the U.S. dollar from 1992 to 2025. The exchange rate increased from 2.07 ETB/USD in 1992 to an estimated 130.82 ETB/USD by 2025, reflecting policy shifts from a fixed to a managed and eventually a floating exchange rate system.

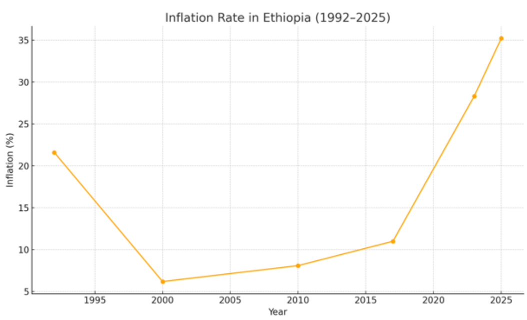

Figure 4: Inflation Rate in Ethiopia (1992–2025)

This figure presents the trend in annual inflation rates in Ethiopia between 1992 and 2025. The sharp rise in inflation in the post-2020 period corresponds with increased exchange rate volatility and currency depreciation under the transition to a floating exchange rate regime.

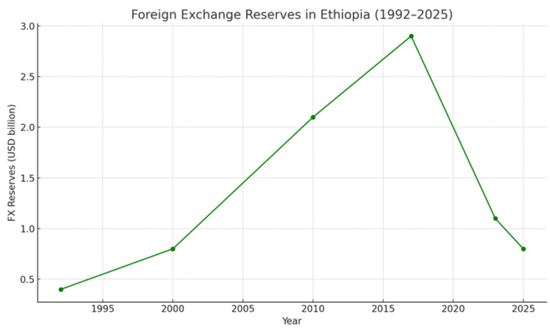

Figure 5: Foreign Exchange Reserves in Ethiopia (1992–2025)

This figure shows Ethiopia's foreign exchange reserves in U.S. dollars from 1992 to 2025. The data reveal a general increase until 2017, followed by a marked decline through 2025, indicating growing external vulnerability during the transition to a floating exchange rate system.

4.4. Comparative Experiences and Quantitative Insights

To contextualize Ethiopia's currency flotation, this study compares macroeconomic outcomes in other African countries that have undertaken similar reforms. Table 2 presents a quantitative summary of key indicators before and after floatation in Egypt, Nigeria, Ghana, and South Africa.

These countries offer a spectrum of outcomes. Egypt's 2016 flotation, for example, was accompanied by a sharp depreciation and inflation spike, followed by increased reserves and moderate GDP recovery due to IMF-supported stabilization (2020). Ghana demonstrated resilience due to strong fiscal discipline and export diversification. Nigeria's partial float led to volatility and inflation due to inconsistent policy execution. South Africa’s long-standing float demonstrates how institutional maturity cushions volatility.

Ethiopia, by comparison, is experiencing a steeper depreciation and projected inflation rate increase than its peers. This raises concerns about external vulnerability, particularly given the concurrent decline in foreign exchange reserves. These patterns underscore the importance of policy coherence, institutional readiness, and targeted social protection.

Table 2: Comparative Summary of Exchange Rate Reforms in Selected African Countries

Country	Year of Floatation	Pre-Float Inflation (%)	Post-Float Inflation (%)	Exchange Rate Change (%)	FX Reserves Change (%)	GDP Growth Impact	Key Outcome
Ethiopia	2023 (in progress)	28.3	35.2	+118%	-27%	↓ from 5.4% to 4.0% (est.)	Inflationary, ongoing risk
Egypt	2016	10.3	23.5	+48%	+80%	↓ then ↑ to 5.3%	Stabilized with IMF support
Nigeria	2016 (partial)	9.5	15.7	+35%	-15%	↓ to 1.9%	Unstable due to policy inconsistency
Ghana	2007	10.7	16.9	+29%	Stable	↑ to 7.3%	Relatively successful
South Africa	Longstanding	4.8	6.3	Minor fluctuations	Stable	~steady 1.3–2.0%	Resilient due to strong institutions

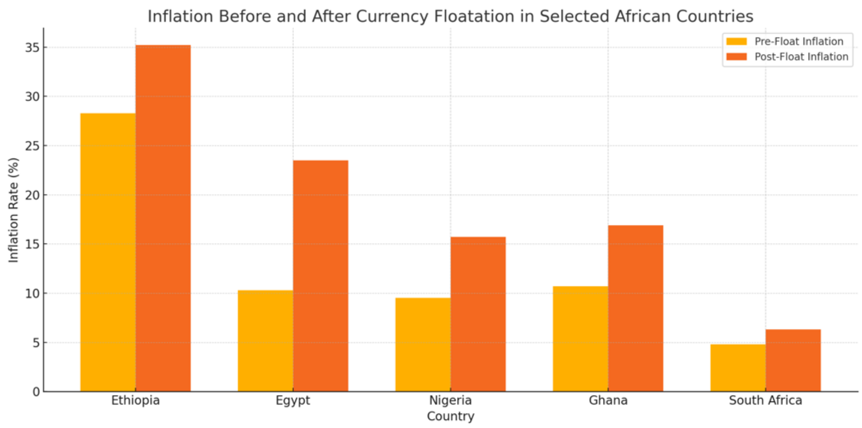

Figure 6: *Inflation Rates Before and After Currency Floatation in Selected African Countries*
This chart compares the inflation rates prior to and following exchange rate liberalization. Countries like Egypt and Ghana experienced short-term spikes in inflation, followed by relative stabilization, while Nigeria’s inconsistent implementation led to sustained inflationary pressure. Ethiopia’s post-float inflation is projected to rise further, underscoring the need for strong policy responses.

Together, the table and chart highlight both the opportunities and risks of floating exchange rates. The evidence suggests that success depends less on the policy itself and more on how well it is supported by institutional frameworks, governance transparency, and adaptive social policies.

5. Implications of Floating Exchange Rate on Ethiopia’s Political Economy

The adoption of a floating exchange rate system presents Ethiopia with both significant opportunities and complex challenges from a political economy perspective. One of the primary advantages lies in the enhanced economic sovereignty it offers. By allowing the Ethiopian central bank to prioritize domestic macroeconomic objectives such as inflation control and sustainable economic growth without the constraints of defending a fixed exchange rate, the country gains greater policy flexibility (Krugman & Obstfeld, 2021). Market-determined exchange rates also enable the preservation of scarce foreign exchange reserves for critical imports such as fuel and food, which are essential for economic stability (IMF, 2023c).

The depreciation of the Birr under a floating regime can increase trade competitiveness by making Ethiopian exports such as coffee, textiles, and horticultural products more attractive in international markets (World Bank, 2022c). However, this potential gain is accompanied by significant trade-offs. As the cost of importing essential goods like machinery, fuel, and raw materials rises, inflationary pressures are likely to intensify, increasing production costs and reducing purchasing power (Rodrik, 2008b).

These inflationary effects are particularly acute in economies such as Ethiopia’s, which rely heavily on imports. Rising prices can erode real incomes and trigger social discontent, thereby posing risks to political stability and public trust in government institutions (Mankiw, 2021b; Reinhart & Rogoff, 2009). Moreover, heightened currency volatility may undermine investor confidence and long-term business planning. If the Birr continues to depreciate unpredictably, it may prompt capital flight and discourage foreign direct investment, especially if investors anticipate further macroeconomic instability (Rodrik, 2008b; Krugman & Obstfeld, 2021).

For a floating exchange rate system to function effectively, it must be underpinned by credible and independent monetary institutions. The strength and autonomy of the National Bank of Ethiopia will be pivotal in maintaining policy credibility and market confidence (IMF, 2023b). The increased visibility of macroeconomic imbalances under a floating system can also serve as a disciplining force, pressuring policymakers to adopt more responsible and transparent fiscal policies (Reinhart & Rogoff, 2009).

Ethiopia’s structural vulnerabilities compound the risks associated with currency depreciation. The country’s dependence on imported goods, particularly food and fuel, makes it highly susceptible to external price shocks. This exposure underscores the urgent need for economic diversification and reduced import dependency (World Bank, 2022c). Furthermore, Ethiopia’s export base remains narrow and largely concentrated in primary commodities, which are often subject to volatile global prices. Such a limited export structure increases the economy's sensitivity to global market fluctuations and weakens its resilience to exchange rate shocks (Rodrik, 2008c).

The social and political ramifications of floating the Birr are no less significant. Inflation and currency depreciation tend to disproportionately affect low-income households, thereby deepening existing inequalities and potentially inciting political unrest (Mankiw, 2021b). These effects are particularly concerning in a context like Ethiopia’s, where socioeconomic disparities intersect with ethnic and regional divisions. Uneven distribution of the policy’s benefits could exacerbate tensions and challenge national cohesion (World Bank, 2022c).

On the international front, a floating exchange rate may facilitate greater integration into global financial markets by creating a more transparent and market-oriented economic environment. This can be attractive to international investors seeking stability and predictability in policy regimes (IMF, 2023c). However, deeper global integration also exposes the country to external shocks such as global commodity price fluctuations and international economic downturns which can further complicate domestic economic management (Rodrik, 2008c).

In sum, while a floating exchange rate offers Ethiopia increased flexibility and long-term potential for improved macroeconomic management, it also introduces a new layer of complexity to the country's political economy. Its success will ultimately depend on the government’s ability to implement complementary reforms, strengthen institutions, manage inflation, and address the distributional consequences of economic adjustment in an inclusive and equitable manner.

5.1. Stakeholder Perspectives and Sectoral Readiness for Exchange Rate Liberalization

Understanding the policy implications of Ethiopia’s shift to a floating exchange rate requires not only macroeconomic analysis but also insight into how various stakeholders perceive and are affected by the reform. These include businesses, financial institutions, households, and policymakers each of whom will experience different risks and opportunities.

Private sector stakeholders, particularly import-dependent industries, express concerns over rising input costs and supply chain disruptions caused by currency depreciation. Sectors such as manufacturing, construction, and retail rely heavily on imported machinery, raw materials, and fuel. As these costs rise, firms may reduce production or pass expenses onto consumers, contributing to inflationary pressure. Export-oriented industries, such as agriculture and textiles, may benefit in the medium term from improved global price competitiveness; however, these sectors often face infrastructural and logistical bottlenecks that limit their ability to scale up quickly in response to favorable exchange rates.

Small and medium enterprises (SMEs), which form the backbone of Ethiopia’s domestic economy, are particularly vulnerable. Most SMEs lack access to foreign exchange hedging tools or credit facilities to weather short-term shocks. Their financial fragility could lead to closures, job losses, or informalization of economic activity if support mechanisms are not introduced.

Financial institutions also face increased risk exposure. Commercial banks must manage currency mismatches between assets and liabilities, especially if dollar-denominated liabilities become harder to service. The National Bank of Ethiopia (NBE) will need to rapidly strengthen its supervisory role, risk assessment capabilities, and foreign exchange market infrastructure. Without robust central bank independence and a clear policy rule, investor confidence may deteriorate.

Households, especially low-income urban consumers, are already experiencing erosion of real income due to rising prices of imported goods such as food, fuel, and pharmaceuticals. In the absence of effective social safety nets, currency flotation could exacerbate inequality, food insecurity, and public dissatisfaction. Vulnerable groups may also be more susceptible to economic shocks due to their exclusion from formal banking systems. Therefore, financial inclusion through savings and credit cooperatives (SACCOs), mobile money, and microfinance will be essential in ensuring social protection during this transition.

Public sector institutions, including ministries of finance, trade, and planning, must coordinate closely to manage the broader economic implications of the float. Delays or inconsistencies in communication could create market confusion, increase speculative behavior, or trigger a political backlash. Building institutional readiness also involves training civil servants, improving forecasting models, and strengthening fiscal rules to prevent inflationary fiscal expansions.

From a governance perspective, transparency and stakeholder engagement are critical for building public trust and managing expectations. Communicating the rationale, risks, and compensatory measures of the floatation policy to the public will help prevent misinformation and reduce the likelihood of protests or social unrest. Stakeholder buy-in particularly from labor unions, business associations, and civil society will improve policy compliance and legitimacy. Moreover, Ethiopia's transition to a floating exchange rate regime must be supported by a multi-sectoral, multi-stakeholder strategy. The readiness of key sectors and institutions to adapt will be a defining factor in the success or failure of this reform. Without coordinated support, the policy may deepen economic vulnerabilities rather than resolve them.

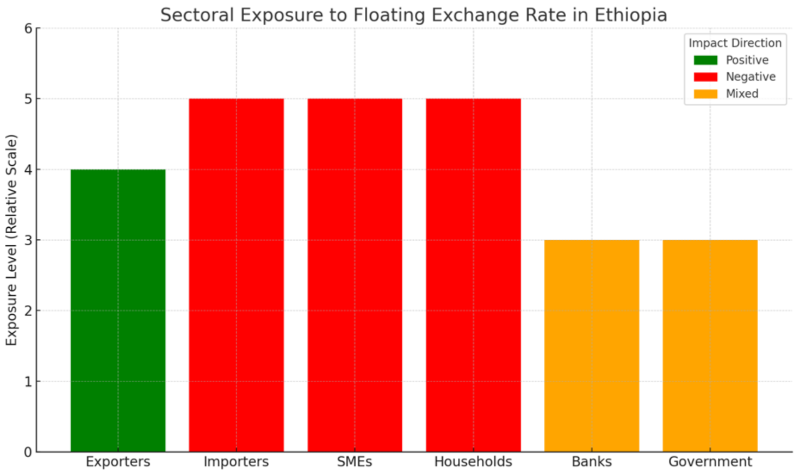

Figure 7: *Sectoral Exposure and Impact Direction from Ethiopia's Transition to a Floating Exchange Rate*
This figure categorizes key sectors based on their relative exposure to exchange rate volatility and indicates the likely direction of impact. While exporters may benefit from improved competitiveness, sectors such as importers, SMEs, and households face high exposure and predominantly negative consequences. Financial institutions and government sectors experience mixed effects, depending on policy coordination and institutional readiness.

6. Future Pathways

Successfully managing the transition to a floating exchange rate system in Ethiopia requires a comprehensive set of strategic interventions. Foremost among these is the need to strengthen the independence and capacity of the National Bank of Ethiopia (NBE). An autonomous central bank, equipped with technical expertise and policy credibility, is vital for managing currency fluctuations and implementing market-oriented monetary policies effectively (Reinhart & Rogoff, 2009). In parallel, reducing the country's reliance on imports and volatile primary commodities is essential to mitigate exposure to external shocks and foster greater macroeconomic resilience (IMF, 2023c).

Equally critical is the need to address the social implications of this monetary transition. Ethiopia must develop targeted social protection programs to shield vulnerable groups from the inflationary pressures and economic volatility that are likely to accompany a more flexible exchange rate regime. These measures may include food subsidies, income support schemes, and expanded access to financial services through microfinance institutions and savings and credit cooperatives (World Bank, 2022c; Mankiw, 2021b). Ensuring that the burdens and benefits of currency reform are equitably distributed is imperative to maintain public trust and political stability.

Regional cooperation will also play a vital role in supporting Ethiopia's adjustment. As a landlocked country, Ethiopia's economic trajectory is closely linked to its integration with neighboring economies, particularly through regional bodies such as the East African Community (EAC) and the Common Market for Eastern and Southern Africa (COMESA). Participation in these frameworks can help Ethiopia mitigate some of the risks associated with exchange rate volatility by expanding trade networks, securing preferential market access, and diversifying export destinations (World Bank, 2022c). These alliances can also facilitate the development of cross-border infrastructure, including transportation corridors and digital payment systems, which lower the cost of trade and enhance market connectivity.

Moreover, deeper regional financial integration can provide a buffer against capital outflows and exchange rate instability. Strengthened ties with regional financial hubs such as Kenya could enable more efficient liquidity management, expand access to capital markets, and foster policy harmonization across borders (Rodrik, 2008c). Infrastructure investments in ports, railways, and roads would further bolster Ethiopia's export competitiveness by easing logistical constraints and facilitating access to neighboring markets, even amid currency fluctuations (IMF, 2023b). Regional economic coordination could also serve as a platform for collective responses to external shocks, such as commodity price crashes or currency crises, thereby contributing to long-term economic security.

Internally, Ethiopia must continue to build institutional capacity and improve transparency in monetary and fiscal policy implementation. Clear, consistent communication from the central bank will be essential to maintaining investor confidence and managing inflation expectations. At the same time, efforts to diversify the export base by promoting value-added production, industrialization, and technological innovation are necessary to reduce reliance on volatile commodity exports and build a more resilient economic foundation (World Bank, 2022c).

A coordinated macroeconomic strategy is also indispensable. Fiscal and monetary policies must be tightly aligned to avoid amplifying inflationary pressures or creating policy contradictions. Emphasis should be placed on developing industrial capacity and enhancing productivity across sectors, enabling Ethiopia to shift from an import-dependent growth model to one anchored in domestic production and innovation (Rodrik, 2008c; Reinhart & Rogoff, 2009). Collectively, these measures will establish a robust framework for navigating the complexities of a floating exchange rate regime while fostering sustainable, inclusive growth.

7. Limitations and Future Research Directions

While this study offers a comprehensive analysis of Ethiopia's transition to a floating exchange rate by integrating theoretical insights, policy reviews, and comparative case studies, it is primarily based on secondary sources. Consequently, one limitation is the absence of original empirical data or econometric modeling to statistically validate the observed trends and projected outcomes.

Future research should prioritize empirical validation through quantitative methods. This could involve a time-series analysis of Ethiopia's macroeconomic indicators such as inflation, exchange rates, foreign reserves, and trade performance before and after the implementation of the floating exchange rate regime. Econometric techniques such as Vector Autoregression (VAR), Autoregressive Distributed Lag (ARDL) models, or Difference-in-Differences (DiD) could be employed to isolate the causal impact of the policy shift. In addition, firm-level and household-level surveys could offer microeconomic insights into how different segments of society are responding to exchange rate fluctuations.

Moreover, a panel data comparison with other African countries that adopted floating regimes could strengthen generalizability and reveal policy interactions. These empirical approaches would not only validate the hypotheses presented in this study but also offer robust, data-driven recommendations for policymakers. Integrating these methodologies in future research will enhance the scientific rigor of exchange rate policy analysis in the Ethiopian context and contribute meaningfully to the broader literature on monetary reform in developing economies.

8. Conclusions

This This study has examined the rationale behind Ethiopia's decision to adopt a floating exchange rate, assessed its economic and institutional implications, and identified strategic pathways for managing the transition. Drawing on a comprehensive review of theoretical frameworks and international case studies, the analysis reveals that the flotation of the Ethiopian Birr represents a pivotal shift in the country's macroeconomic architecture. It offers opportunities for increased monetary policy autonomy, enhanced trade competitiveness, and deeper integration into global markets. However, it also introduces considerable risks—including inflation, exchange rate volatility, and potential social and political tensions that must be carefully managed.

The success of this policy shift will depend on Ethiopia's ability to implement sound macroeconomic management, strengthen institutional frameworks, and adopt structural reforms aimed at reducing import dependency and diversifying exports. Lessons from countries such as Egypt, Nigeria, Ghana, and South Africa demonstrate that floating exchange rate regimes can yield positive outcomes when supported by consistent policy implementation, strong institutions, and effective communication. Ethiopia's experience, however, will be shaped by its unique economic, political, and regional context.

Future research should deepen the understanding of the macroeconomic, social, and institutional impacts of Ethiopia's currency reform. In particular, studies should assess the short- and long-term effects of exchange rate flexibility on inflation, trade balances, capital flows, and foreign direct investment. Additionally, more attention must be paid to the distributional consequences of currency depreciation, particularly for low-income households and small businesses, and to the role of financial inclusion in mitigating these effects.

Comparative research with other African economies that have undergone similar reforms will provide valuable insights into best practices and policy pitfalls. Further investigation into the role of SACCOs, microfinance institutions, and other grassroots financial actors will be critical for understanding how to shield vulnerable populations from the adverse impacts of exchange rate shocks. Research should also explore the readiness of Ethiopia's financial sector to manage the increased complexity and risks associated with currency liberalization.

Finally, future studies must consider the political dimensions of floating exchange rate regimes—particularly issues of public trust, policy credibility, and governance. Understanding how the public perceives monetary reforms, and how governments can build legitimacy through transparency and accountability, will be key to ensuring stability throughout the reform process. By addressing these issues, future research can offer evidence-based recommendations to support Ethiopia's transition and maximize the developmental benefits of a market-based exchange rate system.

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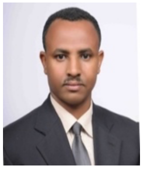

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