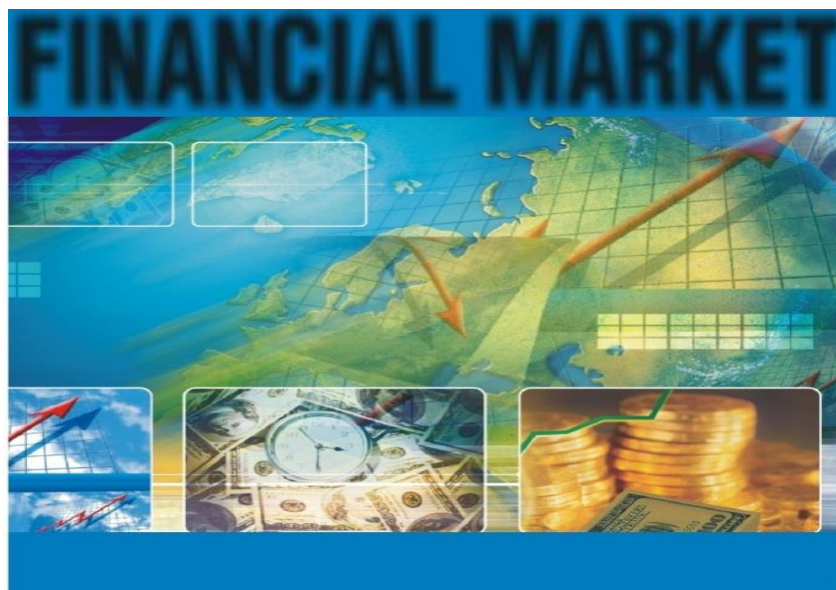


# ACCOUNTING AND FINANCE

## LEVEL – II

**Based on November, 2022, Curriculum Version-II**



**MODULE TITLE: Develop Understanding of the Ethiopian Financial System and Markets**

**MODULE CODE: LSA ACF2 M06 1122**

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**Prepared by Ministry of Lobar and skill**

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**Adama, Ethiopia**

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## Acknowledgment

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## Acronym

NBE	National Bank of Ethiopia
MFI	Micro Finance Institution
NGO	Non- governmental organization
ATM	Automatic teller machine
MD	Money demand
CP	Commercial pepar
CD	Certificate deposit
SFI	Special financial institution
WPC	World pension council
CRD	Capital requirement directive

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## INTRODUCTION

This unit describes the performance outcomes, skills and knowledge required to understand of the financial systems and markets operating in Ethiopia, including identifying the main participants in financial markets, the role of the National Bank, the impact of its decisions on business and consumers, key factors that influence the Ethiopian economy and the role of financial regulators.

The Develop Understanding of the Ethiopian Financial System and Markets plays the key role in the economy by stimulating economic growth, influencing economic performance of the actors, affecting economic welfare. This is achieved by financial infrastructure, in which entities with funds allocate those funds to those who have potentially more productive ways to invest those funds. A financial system makes it possible a more efficient transfer of funds. As one party of the transaction may possess superior information than the other party, it can lead to the information asymmetry problem and inefficient allocation of financial resources. By overcoming the information asymmetry problem the financial system facilitates balance between those with funds to invest and those needing funds.

### **This module covers the Units**

- The Ethiopian financial markets
- Function and role of the National Bank of Ethiopia (NBE)
- Ethiopia's monetary system
- The key Factors influence Ethiopian economy
- The role of financial regulators

### **Learning Objectives of the module**

**Dear learner after completing this competency you will be able to:**

- Define Ethiopian financial markets
- Explain the function and role of the National Bank of Ethiopia (NBE)
- Explain Ethiopia's monetary system
- Identify the key factors that influence the Ethiopian economy
- Monitor and regulate financial market

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## Unit one: - The Ethiopian financial markets

This learning guide is developed to provide you the necessary information regarding the following content coverage and topics:

- Identifying and discussing specific financial markets
- Discussing the purpose of financial markets
- Researching the emergence of Financial Market
- Differencing primary and secondary Market
- Identifying and discussing participants in the financial markets and their role

This guide will also assist you to attain the learning outcomes stated in the cover page.

Specifically, upon completion of this learning guide, you will be able to:

- Identify Specific financial markets in Ethiopia
- Emerge financial markets in Ethiopia
- Identify the participants in the financial markets and role of banks and financial institutions as financial intermediaries



## 1.1. Identifying and discussing specific financial markets

### 1.1. 1. Definition of 'Financial Market'

Financial Market is a Broad term describing any marketplace where buyers and sellers participate in the trade of assets such as equities, bonds, currencies and derivatives. Financial markets are typically defined by having transparent pricing, basic regulations on trading, costs and fees and market forces determining the prices of securities that trade. Some financial markets only allow participants that meet certain criteria, which can be based on factors like the amount of money held, the investor's geographical location, knowledge of the markets or the profession of the participant.

**financial market** is a market in which people and entities can trade financial securities, commodities, and other fungible items of value at low transaction costs and at prices that reflect supply and demand. Securities include stocks and bonds, and commodities include precious metals or agricultural goods.

There are both general markets (where many commodities are traded) and specialized markets (where only one commodity is traded). Markets work by placing many interested buyers and sellers, including households, firms, and government agencies, in one "place", thus making it easier for them to find each other. An economy which relies primarily on interactions between buyers and sellers to allocate resources is known as a market economy in contrast either to a command economy or to a non-market economy such as a gift economy.

### 1.1.2. Financial markets in Ethiopia

**Bond market:** - Bond markets, which provide financing through the issuance of bonds, and enable the subsequent trading thereof.

**Derivatives markets:** - Derivatives markets, which provide instruments for the management of financial risk

**Foreign exchange market:** - Foreign exchange markets, which facilitate the trading of foreign exchange

**Money market:** - Money markets, which provide short term debt financing and investment.

**Options and futures markets:** - Futures markets, which provide standardized forward contracts for trading products at some future date; see also forward market.

**According to the structural approach,** the financial system of an economy consists of three main components:

- A. Financial markets;
- B. Financial intermediaries (institutions);
- C. Financial regulators.

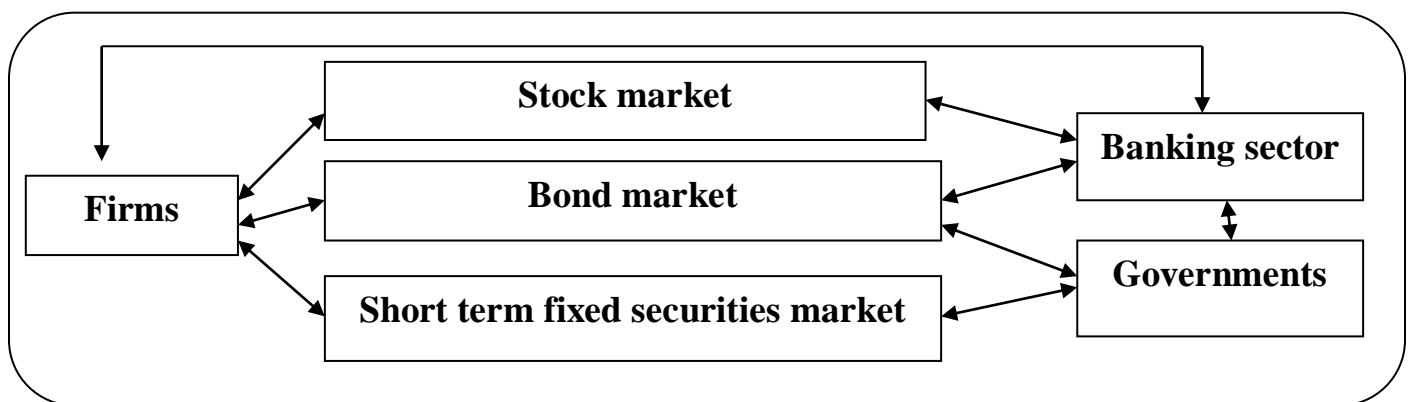
Each of the components plays a specific role in the economy. According to the

**Functional approach,**

**A. Financial markets** facilitate the flow of funds in order to finance investments by corporations, governments and individuals.

**B. Financial institutions** are the key players in the financial markets as they perform the function of intermediation and thus determine the flow of funds.

**C. Financial regulators** perform the role of monitoring and regulating the participants in the financial system.



**Figure 1.1. The structure of financial system**

## 1.2. Purpose of Financial markets

Financial markets studies, based on capital market theory, focus on the financial system, the structure of interest rates, and the pricing of financial assets. An **asset** is any resource that is Expected to provide future benefits, and thus possesses economic value. Assets are divided into two categories: **tangible assets** with physical properties and **intangible assets**. An *intangible*

*asset* represents a legal claim to some future economic benefits. The value of an intangible asset bears no relation to the form, physical or otherwise, in which the claims are recorded.

**Financial assets**, often called **financial instruments**, are intangible assets, which are expected to provide future benefits in the form of a claim to future cash. Some financial instruments are called *securities* and generally include **stocks** and **bonds**. Any transaction related to financial instrument includes at least two parties:

- 1) The party that has agreed to make **future cash payments** and is called the issuer;
- 2) The party that owns the financial instrument, and therefore the **right to receive the Payments** made by the issuer, is called the investor.

Financial assets exist in an economy because the savings of various **individuals, corporations, and governments** during a period of time differ from their investment in real assets. By real assets, we mean such thing as houses, buildings, equipment, inventories, and durable goods. If savings equaled investment in real assets for all economic units in an economy over all periods of time, there would be no external financing, no financial assets, and money or capital markets. Each economic unit would be self-sufficient.

Current expenditures and investment in real assets would be paid for out of current income. A financial asset is created only when the investment of an economic unit in real assets exceeds its savings and it finances this excess by borrowing or issuing stock. Of course, another economic unit must be willing lend.

This interaction of borrowers with lenders determines interest rates. In the economy as a whole, savings-surplus units those whose savings exceed their investment to real assets provide funds to savings deficit units (those whose investments in real assets exceed their savings). This exchange of funds is evidenced by investment instruments, or securities, representing financial assets to the holders and financial liabilities to the issuers.

The purpose of financial markets in an economy is to allocate savings efficiently to ultimate users. If those economic units that saved were the same as those that engaged in capital formation, an economy could prosper without financial markets. In modern economies, however, most non-financial corporations use more than their total savings for investing in real assets.

Most households, on the other hand, have total savings in excess of total investment. Efficiency entails bringing the ultimate investor in real assets and the ultimate saver together at the least possible cost and inconvenience.

Financial markets are not so much physical places as they are mechanisms for channeling savings to the ultimate investors in real assets. The role of financial markets and financial institutions in moving funds from the saving sector (savings-surplus units) to the investment sector (savings-deficit units). From the prominent position held by certain financial institutions in channeling the flow of funds in the economy, the secondary market, financial intermediaries, and financial brokers are the key institutions that enhance funds flows

### 1.3. Researching the emergence of Financial Market

**Emergence markets** are markets where transactions take place all day makers are ensuring market liquidity at moment.

**Dealer market** is the market in which dealers publicly post bid and ask prices simultaneously, and these become firm commitments to make transaction at the prices for a specific transaction volume. Investors are addressing the dealers offering the best price (quote).

**Auction market** is a market in which the supply and demand of securities are matched directly and the price is formed as an equilibrium price.

An **open outcry** system allows brokers to negotiate loudly until price, which is equilibrium of buy and sell orders, is determined. In a **call auction** market all orders are put into an order book until an auction and are executed at a single price. Liquidity requires that such trades take place one or several times during a day. Such trading procedures are aimed at defining the auction price that maximizes the trading volume.

### 1.4. Differencing primary and secondary Market

**Primary market:** - Primary market is a market for new issues or new financial claims. Hence it's also called new issue market. The primary market deals with those securities which are issued to the public for the first time. When equity shares are initially issued, they are said to be sold in the **primary market**

Equity can be issued either privately (unquoted shares) or publicly via shares that are listed On a stock exchange (quoted shares).

**Public market** offering of new issues typically involves the use of an investment bank in a Process, which is referred to as the *underwriting of securities*.

**Private placement market** includes securities which are sold directly to investors and are not registered with the securities exchange commission. There are different regulatory requirements for such securities. In the private equity market, venture capital is often provided by investors as ‘start-up’ money to finance new, high-risk companies in return for obtaining equity in the company. In general private placement market is viewed as illiquid. Such a lack of liquidity means that buyers of shares may demand a premium to compensate for this unappealing feature of a security.

### **Primary equity market**

When equity shares are initially issued, they are said to be sold in the **primary market**. Equity can be issued either privately (unquoted shares) or publicly via shares that are listed on a stock exchange (quoted shares).

**Public market** offering of new issues typically involves the use of an investment bank in a Process, which is referred to as the *underwriting of securities*.

**Private placement market** includes securities which are sold directly to investors and are not registered with the securities exchange commission. There are different regulatory requirements for such securities. In the private equity market, venture capital is often provided by investors as ‘start-up’ money to finance new, high-risk companies in return for obtaining equity in the company. In general private placement market is viewed as illiquid. Such a lack of liquidity means that buyers of shares may demand a premium to compensate for this unappealing feature of a security.

**Secondary market:** - It’s a market for secondary sale of securities. In other words, securities which have already passed through the new issue market are traded in this market. Generally, such securities are quoted in the stock exchange and it provides a continuous and regular market for buying and selling of securities. If a company is already listed and issues additional shares, it is called **seasoned equity offering** or **secondary public offering**. When a firm issues equity at a stock **Secondary equity market** Equity instruments are traded among investors in a **secondary market**, in which no new Capital is raised and the issuer of the security does not benefit directly from the sale. Secondary markets are also classified into **organized stock**

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**exchanges** and **over-the counter markets**. Apart from legal structure, numerous historical differences are found in the operations of National stock markets. The most important differences are in the trading procedures. The trading on secondary markets takes place among investors, however most often through specialized intermediaries - stock brokers (dealers), who buy or sell securities for their clients.

### **1.5. participants in the financial markets and their role**

- Banks and non-banking financial institutions
- Investors:
- Corporations
- Individuals
- Local and international governments

#### **Insurance Companies**

- Issue contracts to provide a future payment if a certain event happens
- Use the fees from these contracts to invest in equities, debt and property

#### **Finance Companies (short to medium term debt capital)**

- Get funds by issuing debentures and borrowing from the general public
- Provide short-to-medium-term funds to business, particularly leasing finance

#### **Banks**

- Are the largest providers of funds to business
- Get most of their funds from deposits
- Provide a wide range of debt securities to business

#### **Merchant Banks**

- Get funds by short-term borrowing
- Lend mainly to corporations in such things as foreign currency and commercial bills

## Companies

- Often have surplus funds from operations
- Invest funds on money market, commercial bills and sometimes buy shares in businesses

## Superannuation/Mutual Funds

- Get funds from the savings of people preparing for retirement
- Invest funds on money market, commercial bills and sometimes buy shares in businesses

## Government (National Bank of Ethiopia)

- Acts for the government to ensure gaps in the supply of funds are filled
- Works through the authorized dealers

There are two basic **financial market participant** categories Investor vs. Speculator and Institutional vs. Retail .

### Supply side vs. demand side

A market participant may either be coming from the Supply Side, hence supplying excess money (in the form of investments) in favor of the demand side; or coming from the Demand Side, hence demanding excess money (in the form of borrowed equity) in favor of the Supply Side. This equation originated from Keynesian Advocates. The theory explains that a given market may have excess cash; hence the supplier of funds may lend it; and that in need of cash may borrow the funds supplied. Hence, the equation: aggregate savings equals aggregate investments. The demand side consists of: those in need of cash flows (daily operational needs); those in need of interim financing (bridge financing); those in need of long-term funds for special projects (capital funds for venture financing).

The supply side consists of: those who have aggregate savings (retirement funds, pension funds, insurance funds) that can be used in favor of demand side. The origin of the savings (funds) can be local savings or foreign savings. So much pensions or savings can be invested for school buildings; orphanages; (but not earning) or for road network (toll ways) or port development



(capable of earnings). The earnings go to owner (Savers or Lenders) and the margin goes to the banks. When the principal and interest are added up, it will reflect the amount paid for the user (borrower) of the funds.

### **Investor vs. Speculator**

An **investor** is any party that makes an Investment.

However, the term has taken on a specific meaning in finance to describe the particular types of people and companies that regularly purchase equity or debt securities for financial gain in exchange for funding an expanding company. Less frequently the term is applied to parties who purchase real estate, currency, commodity derivatives, personal property, or other assets.

**Speculation**, in the narrow sense of financial speculation, involves the buying, holding, selling, and short-selling of stocks, bonds, commodities, currencies, collectibles, real estate, derivatives or any valuable financial instrument to profit from fluctuations in its price as opposed to buying it for use or for income via methods such as dividends or interest. Speculation or **agiotage** represents one of three market roles in western financial markets, distinct from hedging, long term investing and arbitrage. Speculators in an asset may have no intention to have long term exposure to that asset.

### **Institutional investor**

An institutional investor is an investor, such as a bank, insurance company, retirement fund, hedge fund, or mutual fund that is financially sophisticated and makes large investments, often held in very large portfolios of investments. Because of their sophistication, institutional investors may often participate in private placements of securities, in which certain aspects of the securities laws may be inapplicable.

### **Retail investor**

A retail investor is an individual investor possessing shares of a given security. Retail investors can be further divided into two categories of share ownership.

1. A Beneficial Shareholder is a retail investor who holds shares of their securities in the account of a bank or broker, also known as “in Street Name.” The broker is in possession of the securities on behalf of the underlying shareholder.



2. A Registered Shareholder is a retail investor who holds shares of their securities directly through the issuer or its transfer agent. Many registered shareholders have physical copies of their stock certificates.

## Self check

### Part I choose the best answers

#### 1. Which one of Financial markets in Ethiopia?

- a. bond market
- b. derivatives markets
- c. foreign exchange market
- d. money market including the short term money market
- e. options and futures markets
- f. all are answers

#### 2. Which one of Participants in the financial markets?

- a. banks and non-banking financial institutions
- b. investors:
- c. corporations
- d. individuals
- e. local and international governments
- f. all

#### 3. The market place where buyers and sellers trade financial assets is called

- A. Financial system    B. financial market    C. Monetary system    D. None

#### 4. The Financial market which does not exist but is undertake in Ethiopian financial market currently is

- A. Capital market    B. Money market    C. Bond market    D. None

#### 5. Financial market helps bring about

- A. Investment    B. conflict    C. disturbance    D. none

### Part II Give short answers

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1. Mention some of the financial markets in Ethiopia and Explain.

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2. What is financial market?

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3. List the purpose of financial markets and Explain.

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4. Who are Major Participants in Financial Markets?

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## Unit Two: Function and role of the National Bank of Ethiopia (NBE)

This unit to provide you the necessary information regarding the following content coverage and topics:

- Discussing the role of the NBE as Ethiopia's central bank
- Discussing the importance and effect of the NBE's monetary policy

This guide will also assist you to attain the learning outcomes stated in the cover page. Specifically, upon completion of this learning guide, you will be able to:

- Determine the role of the NBE and other banks institutions
- Understand importance and effect of the NBE's Monetary policy on the Ethiopian economy

## 2.1. The role of the NBE

- regulating banks and other financial institutions
- maintaining financial stability and regulating the Ethiopian Payments System
- managing government debt
- regulating the payments system
- Setting and implementing monetary policy

### 2.1.1. The effect of the NBE's monetary policy

May include but not limited to;

- changes in interest rates
- flow on changes to employment, prices and production levels
- increases or decreases in the supply of money in the Ethiopian economy
- acting to avoid or minimise a systemic collapse of financial institutions
- The role of the NBE in regulating the Ethiopian Payments System may include:
  - ✓ fulfilling its regulatory responsibilities by controlling risks and promoting efficiencies
  - ✓ participating in the financial system as banker to the national payment system of government
  - ✓ providing facilities for final settlement of transactions

### 2.1.2. NBE as Ethiopia's central bank is researched with other banking institutions

The National Bank of Ethiopia was established in **1963** by proclamation **206 of 1963** and began operation in January **1964**. Prior to this proclamation, the Bank used to carry out dual activities, i.e. commercial banking and central banking. The proclamation raised the Bank's capital to Ethiopian dollars 10.00 million and granted broad administrative autonomy and juridical personality.

Following the proclamation the National Bank of Ethiopia was entrusted with the following responsibilities.

- To regulate the supply, availability and cost of money and credit.
- To manage and administer the country's international reserves

- To license and supervise banks and hold commercial banks reserves and lend money to them.
- To supervise loans of commercial banks and regulate interest rates
- To issue paper money and coins.
- To act as an agent of the Government.
- To fix and control the foreign exchange rates.

### **Mission, vision, values**

The vision, mission and goals of the National Bank of Ethiopia has emanated from the overall vision of the government which is "to see a country, wherein democracy and good governance are prevailed upon the mutual consent and involvement of its people, wherein social justice is reigned, and wherein poverty reduced and income of the citizens reach to a middle economic level"

#### **2.1.3. National bank and its role in the economy**

The National Bank of Ethiopia has its website at [www.nbe.gov.et/](http://www.nbe.gov.et/) and periodically makes available to the public several statistical publications on macroeconomic factors in Ethiopia.

The inter-bank money market is weak and few banks access the re-discount window.

According to its website, the functions of the National Bank of Ethiopia are as follows:

Coins, prints and issues the legal tender currency, and regulates the country's money supply

- **regulates** the applicable interest rate and other cost of money charges
- **Formulating** implements and follows-up the country's exchange rate policy, and manages and administers the international reserves of the country
- **Licenses**, supervises and regulates the operations of banks, insurance companies and other financial institutions
- **Sets limits** on gold and foreign exchange assets, which banks, and other financial institutions authorized to deal in foreign exchange and hold in deposits
- **Sets limits** on the net foreign exchange positions and terms, and the amount of external indebtedness of banks and other financial institutions

- **Provides short** and long term refinancing facilities to banks and other financial institutions
- **Accepts deposit** of any kind from foreign sources
- **Promotes** and encourages the dissemination of banking and insurance services throughout the country
- **prepares** periodic economic studies, together with forecasts of the balance of payments, money supply, prices and other relevant statistical indicators of the Ethiopian economy useful for analysis and for the formulation and determination by the Bank of monetary, saving and exchange policies
- **Acts as banker**, fiscal agent and financial advisor to the Government
- **represents** the country in international monetary institutions and acts consistently with international monetary and banking agreements to which Ethiopia is a party
- **Exercises and performs** such other powers and activities as central banks customarily

Perform

The Central Bank has a monopoly on all foreign exchange transactions and supervises all foreign exchange payments and remittances. The currency, the Birr, is not convertible. The government carefully monitors and controls its movement and as a result, it trades in a very narrow range.

The Birr is widely considered to be overvalued particularly in light of Ethiopia's high inflation rate.

#### 2.1.4. Goal of the bank

- Carry out extensive and sound institutional transformation tasks.
- Maintain price and exchange rate stability.
- Maintain adequate international reserves.
- Improve the soundness of the financial system.
- Play a decisive role in economic research and policy advice to the Government.
- Create efficient Payment System.
- Improve the currency management of the Bank.

### 2.1.5. Government Bond Market

The Treasury bill market is the only active primary market in the country. Tenders are offered periodically by the Central Bank. The government offers 28-day, 91 day and 182-day bills.

### Other Types of Finance/Financial Market

#### Micro finance

The formal microfinance industry began in Ethiopia in 1994/1995 with the government's the Licensing and Supervision of Microfinance Institution Proclamation designed to encourage Microfinance Institutions (MFIs) to extend credit to both the rural and urban poor of the country. Since the government prohibits any foreign national from providing banking services in Ethiopia, MFIs in the country must be established as share companies with capital wholly owned by Ethiopian Nationals or by organizations wholly owned and registered under the laws with a head office in Ethiopia. These shareholders are precluded from selling or transferring their shares and "voluntarily forsake" their claim on dividends, if any, declared by the MFI. Such shareholders do not have a real stake in the organization and would be unlikely to lend it support at a time of financial crisis.

Interest rates charged on loans are not fixed, but a minimum interest rate of 3% to depositors is required by law, which sometimes discourages mobilization in hard-to-reach areas (where administrative costs added to the cost of capital make investment too expensive). Such high transactions costs mean that most MFIs operate in urban or semi-urban areas, leaving the rural poor underserved. On the other hand, MFIs are exempt from Income and Sales Tax on their profits.

Other than the formally-licensed MFIs, there are NGOs informally involved in the delivery of microfinance. Their practices include subsidized interest rates, charity and lax delinquency penalties, which Obese notes may undermine the health of the microfinance industry as a whole.

In finance, financial markets facilitate:

- The raising of capital (in the capital markets)
- The transfer of risk (in the derivatives markets)
- Price discovery
- Global transactions with integration of financial markets
- The transfer of liquidity (in the money markets)
- International trade (in the currency markets)

– And are used to match those who want capital to those who have it.

Typically a borrower issues a receipt to the lender promising to pay back the capital. These receipts are securities which may be freely bought or sold. In return for lending money to the borrower, the lender will expect some compensation in the form of interest or dividends. This return on investment is a necessary part of markets to ensure that funds are supplied to them.

### Types of financial markets

Within the financial sector, the term "financial markets" is often used to refer just to the markets that are used to raise finance: for long term finance, the Capital markets; for short term finance, the Money markets. Another common use of the term is as a catchall for all the markets in the financial sector, as per examples in the breakdown below.

- **Capital markets** which consist of:
  - ✓ **Stock markets**, which provide financing through the issuance of shares or common stock, and enable the subsequent trading thereof.
  - ✓ **Bond markets**, which provide financing through the issuance of bonds, and enable the subsequent trading thereof.
- **Commodity markets**, which facilitate the trading of commodities.
- **Money markets**, which provide short term debt financing and investment.
- **Derivatives markets**, which provide instruments for the management of financial risk.
- **Futures markets**, which provide standardized forward contracts for trading products at some future date; see also forward market.
- **Insurance markets**, which facilitate the redistribution of various risks.
- **Foreign exchange markets**, which facilitate the trading of foreign exchange.

The capital markets may also be divided into primary markets and secondary markets. Newly formed (issued) securities are bought or sold in primary markets, such as during initial public offerings. Secondary markets allow investors to buy and sell existing securities. The transactions in primary markets exist between issuers and investors, while secondary market transactions exist among investors.



Liquidity is a crucial aspect of securities that are traded in secondary markets. Liquidity refers to the ease with which a security can be sold without a loss of value. Securities with an active secondary market mean that there are many buyers and sellers at a given point in time. Investors benefit from liquid securities because they can sell their assets whenever they want; an illiquid security may force the seller to get rid of their asset at a large discount.

### **The Role of Financial system and economy**

One of the important requisite for the accelerated development of an economy is the existence of a dynamic financial market. A financial market helps the economy in the following manner.

- **Saving mobilization:** Obtaining funds from the savers or surplus units such as household individuals, business firms, public sector units, central government, state governments etc. is an important role played by financial markets.
- **Investment:** Financial markets play a crucial role in arranging to invest funds thus collected in those units which are in need of the same.
- **National Growth:** An important role played by financial market is that, they contributed to a nation's growth by ensuring unfettered flow of surplus funds to deficit units. Flow of funds for productive purposes is also made possible.
- **Entrepreneurship growth:** Financial market contributes to the development of the entrepreneurial class by making available the necessary financial resources.
- **Industrial development:** The different components of financial markets help an accelerated growth of industrial and economic development of a country, thus contributing to raising the standard of living and the society of well-being.

### **Functions of Financial Markets**

- **Intermediary Functions:** The intermediary functions of a financial markets include the following:
- **Transfer of Resources:** Financial markets facilitate the transfer of real economic resources from lenders to ultimate borrowers.

- **Enhancing income:** Financial markets allow lenders to earn interest or dividend on their surplus invisible funds, thus contributing to the enhancement of the individual and the national income.
- **Productive usage:** Financial markets allow for the productive use of the funds borrowed. The enhancing the income and the gross national production.
- **Capital Formation:** Financial markets provide a channel through which new savings flow to aid capital formation of a country.
- **Price determination:** Financial markets allow for the determination of price of the traded financial assets through the interaction of buyers and sellers. They provide a sign for the allocation of funds in the economy based on the demand and supply through the mechanism called price discovery process.
- **Sale Mechanism:** Financial markets provide a mechanism for selling of a financial asset by an investor so as to offer the benefit of marketability and liquidity of such assets.
- **Information:** The activities of the participants in the financial market result in the generation and the consequent dissemination of information to the various segments of the market. So as to reduce the cost of transaction of financial assets.

## Financial Functions

- Providing the borrower with funds so as to enable them to carry out their investment plans.
- Providing the lenders with earning assets so as to enable them to earn wealth by deploying the assets in production debentures.
- Providing liquidity in the market so as to facilitate trading of funds.
- it provides liquidity to commercial bank
- it facilitate credit creation
- it promotes savings
- it promotes investment
- it facilitates balance economic growth
- it improves trading floors

## The purpose of financial markets

- enabling participants to invest surplus funds by buying securities
- enabling participants to raise required funds by issuing securities

## Type's security market

- **Money market:** Money market is a market for dealing with financial assets and securities which have a maturity period of up to one year. In other words, it's a market for purely short term funds.
- **Capital market:** A capital market is a market for financial assets which have a long or indefinite maturity. Generally it deals with long term securities which have a maturity period of above one year. Capital market may be further divided into:
  - a. Industrial securities market
  - b. Govt. securities market and
  - c. Long term loans market.
- **Equity markets:** A market where ownership of securities are issued and subscribed is known as equity market. An example of a secondary equity market for shares is the Bombay stock exchange.
- **Debt market:** The market where funds are borrowed and lent is known as debt market. Arrangements are made in such a way that the borrowers agree to pay the lender the original amount of the loan plus some specified amount of interest.
- **Derivative markets:** A market where financial instruments are derived and traded based on an underlying asset such as commodities or stocks.
- **Financial service market:** A market that comprises participants such as commercial banks that provide various financial services like ATM. Credit cards. Credit rating, stock broking etc. is known as financial service market. Individuals and firms use financial services markets, to purchase services that enhance the working of debt and equity markets.

- **Depository markets:** A depository market consist of depository institutions that accept deposit from individuals and firms and uses these funds to participate in the debt market, by giving loans or purchasing other debt instruments such as treasure bills.
- **Non-Depository market:** Non-depository market carry out various functions in financial markets ranging from financial intermediary to selling, insurance etc. The various constituencies in non-depository markets are mutual funds, insurance companies, pension funds, brokerage firms etc.
- **The role of the NBE**
  - ✓ regulating banks and other financial institutions
  - ✓ maintaining financial stability and regulating the Ethiopian Payments System
  - ✓ managing government debt
  - ✓ regulating the payments system
  - ✓ setting and implementing monetary policy
  - ✓ fulfilling its regulatory responsibilities by controlling risks and promoting efficiencies
  - ✓ participating in the financial system as banker to the national payment system of government

providing facilities for final settlement of transactions

## 2.2. Effect of the NBE's monetary policy on the Ethiopian economy

May include but not limited to;

- changes in interest rates
- flow on changes to employment, prices and production levels
- increases or decreases in the supply of money in the Ethiopian economy
- acting to avoid or minimise a systemic collapse of financial institutions
- The role of the NBE in regulating the Ethiopian Payments System may include:
  - ✓ fulfilling its regulatory responsibilities by controlling risks and promoting efficiencies
  - ✓ participating in the financial system as banker to the national payment system of government

## Self check

### Part I choose the best answers

1. Which one is true the effect of the NBE's monetary policy?
  - a. changes in interest rates
  - b. flow on changes to employment, prices and production levels
  - c. increases or decreases in the supply of money in the Ethiopian economy
  - d. acting to avoid or minimise a systemic collapse of financial institutions
  - e. The role of the NBE in regulating the Ethiopian Payments System may include
  - f. all
2. Which one is true about The functions of money?
  - a. as a means of exchange for acquiring goods and services
  - b. indications of relative values between goods and services
  - c. measure of liquidity
  - d. all
6. Which one is true about Motivations for holding money?
  - a. demand for money to pay future expenses
  - b. demand for money to be able to take advantage of future price changes of the purchaser
  - c. Transactions demand for money to pay everyday predictable expenses.
  - d. all
3. Which one is true about Instruments traded on the short term money market?
  - a. bills of exchange
  - b. commercial bills
  - c. government bills
  - d. promissory notes
  - e. Treasury bills.
  - f. all
4. Which one of the role of the NBE?
  - a. regulating banks and other financial institutions
  - b. maintaining financial stability and regulating the Ethiopian Payments System
  - c. managing government debt and regulating the payments system

d. setting and implementing monetary policy  
all

## Give short answer

**1. Dear learner: can you mention some Role of national bank of Ethiopia in the economy?**

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**2. Enumerate types of financial markets**

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**3. How can financial market help the economy?**

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**4. Write Function and role of the National Bank of Ethiopia (NBE)**

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### Unit three: Ethiopia's monetary system

This unit to provide you the necessary information regarding the following content coverage and topics:

- Understanding of the monetary system
- Explaining the various *functions of money*
- Outlining society's *motivations for holding money*
- Describing the monetary cycle within the economy and on a global scale
- Describing *instruments traded on the short term money market*
- Discussing the impact of increases and decreases in the money supply
- Discussing the importance of regulating money supply of any country

This guide will also assist you to attain the learning outcomes stated in the cover page. Specifically, upon completion of this learning guide, you will be able to:

- Determine functions of money *motivations*
- Describe money market instruments on the short term trade
- Understand the impact of increases or decreases in the money supply

### 3.1. Understanding of the monetary system

#### 3.1.1 Explaining the various functions of money

##### The different functions of money

- as a means of exchange for acquiring goods and services
- indications of relative values between goods and services
- measure of liquidity
- precautionary demand for money to pay future expenses which may not be anticipated
- speculative demand for money to be able to take advantage of future price changes in favour of the purchaser
- transactions demand for money to pay everyday predictable expenses

##### the Functions of Money

Money is one of the greatest inventions of a human thought. Perhaps, the whole structure of today's economy is predetermined by the existence of money. But when did money occur and what was the reason for its occurrence? Money is a public institution, which increases wealth by reducing the cost of exchange and contributing to greater specialization in occupation, according to one's comparative advantage. Money appeared due to trade, and since it is established that trade is one of the most ancient occupations of mankind, therefore the emergence of the monetary system can be dated back to the times of antiquity. The origin of money is associated with 7-8 thousand years BC, when primitive tribes understood that they had surplus of some goods, which could be exchanged for other needed products. Historically, as a means of exchange, human used animals, furs, stones, shells etc. So money is determined by society itself, whatever the society recognizes as a means of exchange – is money. Money is an integral element of commodity production, which means its simultaneous development, so it can be considered that money takes certain shapes at each stage of economy, which best correspond to the nature and needs of its current level. Understanding of such terms as money, their role in the economy and the logic of its development...

Money has a major influence on the lives of most people. The more money a person makes, the more goods he can consume and services he can afford, which typically translates into a higher



standard of living. Money, also called currency, is said to have three major functions in an economy.

Money performs four specific functions, each of which overcomes the difficulties of **barter**. The functions of money are to serve as:

### **Medium of Exchange:**

The most important function of money is to serve as a medium of exchange or as a means of payment. To be a successful medium of exchange, money must be commonly accepted by people in exchange for goods and services. While functioning as a medium of exchange, money benefits the society in a number of ways:

- ✓ It overcomes the inconvenience of barter system (i.e., the need for double coincidence of wants) by splitting the act of barter into two acts of exchange, i.e., sales and purchases through money.
- ✓ It promotes transactional efficiency in exchange by facilitating the multiple exchange of goods and services with minimum effort and time,
- ✓ It promotes allocation efficiency by facilitating specialization in production and trade,
- ✓ It allows freedom of choice in the sense that a person can use his money to buy the things he wants most, from the people who offer the best bargain and at a time he considers the most advantageous.

### **3.3. Outlining society's motivations for holding money**

#### **Motivations for holding money**

- precautionary demand for money to pay future expenses which may not be anticipated
- speculative demand for money to be able to take advantage of future price changes in favors of the purchaser
- Transactions demand for money to pay everyday predictable expenses.

**Motivations of Money** serve as a common measure of value in terms of which the value of all goods and services is measured and expressed. By acting as a common denominator or

numeraire, money has provided a language of economic communication. It has made transactions easy and simplified the problem of measuring and comparing the prices of goods and services in the market. Prices are but values expressed in terms of money.

Money also acts as a unit of account. As a unit of account, it helps in developing an efficient accounting system because the values of a variety of goods and services which are physically measured in different units (e.g., quintals, metres, litres, etc.) can be added up. This makes possible the comparisons of various kinds, both over time and across regions. It provides a basis for keeping accounts, estimating national income, cost of a project, sale proceeds, profit and loss of a firm, etc.

To be satisfactory measure of value, the monetary units must be invariable. In other words, it must maintain a stable value. A fluctuating monetary unit creates a number of socio-economic problems. Normally, the value of money, i.e., its purchasing power, does not remain constant; it rises during periods of falling prices and falls during periods of rising prices.

### **Standard of Deferred Payments:**

When money is generally accepted as a medium of exchange and a unit of value, it naturally becomes the unit in terms of which deferred or future payments are stated.

Thus, money not only helps current transactions though functions as a medium of exchange, but facilitates credit transaction (i.e., exchanging present goods on credit) through its function as a standard of deferred payments. But, to become a satisfactory standard of deferred payments, money must maintain a constant value through time ; if its value increases through time (i.e., during the period of falling price level), it will benefit the creditors at the cost of debtors; if its value falls (i.e., during the period of rising price level), it will benefit the debtors at the cost of creditors.

### **Store of Value:**

Money, being a unit of value and a generally acceptable means of payment, provides a liquid store of value because it is so easy to spend and so easy to store. By acting as a store of value, money provides security to the individuals to meet unpredictable emergencies and to pay debts

that are fixed in terms of money. It also provides assurance that attractive future buying opportunities can be exploited.

Money as a liquid store of value facilitates its possessor to purchase any other asset at any time. It was Keynes who first fully realised the liquid store value of money function and regarded money as a link between the present and the future. This, however, does not mean that money is the most satisfactory liquid store of value. To become a satisfactory store of value, money must have a stable value.

### **Transfer of Value:**

Money also functions as a means of transferring value. Through money, value can be easily and quickly transferred from one place to another because money is acceptable everywhere and to all.

## **3.4. Describing the monetary cycle within the economy and on a global scale**

Money facilitates the division of national income between people. Total output of the country is jointly produced by a number of people as workers, land owners, capitalists, and entrepreneurs, and, in turn, will have to be distributed among them. Money helps in the distribution of national product through the system of **wage, rent, interest and profit**.

### **Maximization of Satisfaction:**

Money helps consumers and producers to maximize their benefits. A consumer maximizes his satisfaction by equating the prices of each commodity (expressed in terms of money) with its marginal utility. Similarly, a producer maximizes his profit by equating the marginal productivity of a factor unit to its price.

### **Basis of Credit System:**

Credit plays an important role in the modern economic system and money constitutes the basis of credit. People deposit their money (saving) in the banks and on the basis of these deposits, the banks create credit.

## Liquidity to Wealth:

Money imparts liquidity to various forms of wealth. When a person holds wealth in the form of money, he makes it liquid. In fact, all forms of wealth (e.g., land, machinery, stocks, stores, etc.)

### Reasons why people hold money

**a. The transactions motive:** People need to make day-to-day transactions (buy food, Clothes etc.) and therefore need to hold cash in their hands. Of course, the increasing Spread of plastic money (credit cards) has considerably reduced the transactions incentive for holding money. Assuming no plastic money, an individual's transactions demand for money is likely to increase with his/her income, as s/he is more likely to make more transactions if he feels richer.

**b. Precautionary motive:** In addition to money held for making transactions, people sometimes hold money for precautionary purposes as well: i.e. to meet any urgent or unexpected expenditure needs, or to “snatch a bargain” that might be taken by someone else. Again, precautionary demand for money is likely to increase with income

**c. Assets motive (also called speculative or investments motive):** In addition to a and b, people might wish to keep some cash to switch between various investments. So consider a person who owns some land, holds some bonds, and has some stock market investments. Let's say he spots a good investment opportunity on the stock market but doesn't have instant buyers for the land or bonds he holds. In this situation some spare cash in hand would have helped him acquire the equity asset. The assets demand for money is likely to increase with income (for reasons similar to those for a and b) and decrease with interest rates (because the interest rate is the opportunity cost of holding cash in your hands).

Generally, then, money demand (MD) increases with income levels and falls with interest rates. Note that we refer to real income (which measures purchasing power) and real interest rates (which measure real return on invested money), and not their nominal counterparts. Thus the demand for money we refer to is the demand for real money. Contrast this with what have been talking about earlier: nominal money supply – i.e. what the central bank controls through its various instruments. Whether nominal and real money supply is equal or not depends much

on the assumption regarding prices. If prices are assumed fixed, then the two are equal, otherwise not.

### **The characteristics of money**

The characteristics of what serves as money depend somewhat on the degree of complexity in the society. A relatively simple economy, with relatively few goods and services, few producers and consumers, and few transactions, may be able to function with a form of money that would not work in a more complex society. There are some general characteristics that are usually important for whatever serves as money in a modern economy.

First, to serve as an effective medium of exchange, money must be durable. Repeating our earlier example, we could have chosen to use apples as money and pay for everything in apples. But problems arise when the apples rot. Who wants to carry around rotten apples? Good apples tend to be eaten, and nothing could erode the value of your money more quickly than having it end up in your stomach.

Second, what serves as money must not be easily reproduced by people and should be relatively scarce? We could use chestnuts as money. They're relatively scarce and last a long time. But, if we did, people would start growing chestnut trees, and we wouldn't be able to control the supply. Soon there would be so many chestnuts in use, and prices would be bid up so high, that you'd need a truck to carry the chestnuts to pay for bread and milk. We could use rocks, but everyone can simply pick up rocks from all over the place.

Once again, we wouldn't be able to control the supply, and we'd be back to our chestnut problem.

Third, although what serves as money must be relatively scarce (not rocks, for example), it can't be too scarce. Whatever serves as money has to be available in sufficient quantity to enable all the exchanges in our economy to take place. We could use whooping cranes. But there wouldn't be enough of them to enable all the exchanges that have to take place. We would very quickly run out of money—to say nothing of the poor birds.

Fourth, money has to be easy to transport. We could use elephants. But just think of all the problems at pay-day if elephant money was used to provide your wage or salary. Pocket money would take on a whole, or should we say whole, new meaning.

And last, money must be divisible into usable quantities or fractions. Imagine the difficulties you would incur to purchase something that had a price of 1/50th of an elephant. Not a pleasant thought.

So money needs to be

But, as we emphasized earlier, the most essential attribute of anything that serves as money is its acceptability. It must be readily accepted by people in the economy.

### 3.5. Describing instruments traded on the short term money market

- bills of exchange
- commercial bills
- government bills
- promissory notes
- Treasury bills.

#### Money market instruments

Following are some of the important money market instruments or securities

A **bill of exchange** is an instrument in writing containing an unconditional order, signed by the maker, directing a certain person to pay a certain sum of money only to or to the order of a certain person, or to the bearer of the instrument.

A **promissory note** is an instrument in writing (not being a bank note or a currency note) containing an unconditional undertaking, signed by the maker, to pay a certain sum of money only to or to the order of a certain person or to the bearer of the instrument.

**Call Money:** Call money is mainly used by the banks to meet their temporary requirement of cash. They borrow and lend money from each other normally on a daily basis. It is repayable on demand and its maturity period varies in between one day to a fortnight. The rate of interest paid on call money loan is known as call rate.

**Treasury bill:** A treasury bill is a promissory note issued by the short-term requirement of funds. Treasury bills are a highly liquid instrument, which means, at any time the holder of treasury bills can transfer or get it discounted from Bank and financial institution.

These bills are normally issued at a price less than their face value; and redeemed at face value. So the difference between the issue price and the face value of the Treasury bill represents the

interest on the investment. These bills are secured instruments and are issued for a period of not exceeding 364 days. Banks, Financial institutions and corporations normally play major role in the Treasury bill market.

**Commercial Paper:** Commercial paper (CP) is a popular instrument for financing working capital requirements of companies. The CP is an unsecured instrument issued in the form of promissory note. This instrument was introduced in 1990 to enable the corporate borrowers to raise short-term funds. It can be issued for period ranging from 15 days to one year. Commercial papers are transferable by endorsement and delivery. The highly reputed companies (Blue Chip companies) are the major player of commercial paper market.

**Certificate of Deposit:** Certificate of Deposit (CDs) are short-term instruments issued by Commercial Banks and Special Financial Institutions (SFIs), which are freely transferable from one party to another. The maturity period of CDs ranges from 91 days to one year. These can be issued to individuals, co-operatives and companies.

**Trade Bill:** Normally the traders buy goods from the wholesalers or manufactures on credit. The sellers get payment after the end of the credit period. But if any seller does not want to wait or in immediate need of money he/she can draw a bill of exchange in favor of the buyer. When buyer accepts the bill it becomes a negotiable instrument and is termed as bill of exchange or trade bill. This trade bill can now be discounted with a bank before its maturity. On maturity the bank gets the payment from the drawer i.e., the buyer of goods. When trade bills are accepted by Commercial Banks it is known as Commercial Bills. So trade bill is an instrument, which enables the drawer of the bill to get funds for short period to meet the working capital needs.

## Monetary Cycles

One of the most robust stylized facts is the forecasting power of the term spread for future real activity. The economic rationale for this forecasting power usually appeals to expectations of future interest rates, which affect the slope of the term structure. A possible causal mechanism for the forecasting power of the term spread, deriving from the balance sheet management of financial intermediaries. When monetary tightening is associated with a flattening of the term spread, it reduces net interest margin, which in turn makes lending less profitable, leading to a contraction in the supply of credit

Monetary theories

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Some writers have ascribed economic fluctuations to the quantity of money in circulation. Changes in the money supply do not always conform to underlying economic changes, and it is not difficult to see how this lack of coordination could produce disturbances in the economic system. Thus, an increase in the total quantity of money could cause an increase in economic activity.

The banking system, with its ability to expand the supply of credit in an economic expansion and to contract the supply of credit in time of recession, may in this way amplify small economic fluctuations into major cycles of prosperity and depression. Theorists such as the Swedish economist Knut Wick sell emphasized the influence of the rate of interest: if the rate fixed by the banking system does not correspond to the “natural” interest rate dictated by the requirements of the economy, the disparity may of itself induce an expansion or contraction in economic activity.

#### Rational expectations theories

In the early 1970s the American economist Robert Lucas developed what came to be known as the “Lucas critique” of both monetarist and Keynesian theories of the business cycle. Building on rational expectations concepts introduced by the American economist John Muth, Lucas observed that people tend to anticipate the consequences of any change in fiscal policy: they “behave rationally” by adjusting their actions to take advantage of new laws or regulations, inevitably weakening or undermining them. In some cases, these actions are significant enough to offset completely the outcome the government had hoped to achieve.

Although he was criticized for overstating the connection between human behaviour and economic rationalism, Lucas influenced other 20th-century economists who asserted that business fluctuations resulted from underlying changes in the economy. Historically, according to their view, economic fluctuations have been marked by periods of innovation followed by slower periods during which the innovations were absorbed. Business cycles, therefore, serve as adjustments to underlying conditions—adjustments that are necessary if economic growth is to continue.

Since the Great Depression, many governments have implemented anticyclical policies designed to offset regular business fluctuations. The increasing complexity and diversification of modern



economies, however, have tended to reduce their dependence on any one sector, thereby limiting the possibility of boom-and-bust effects resulting from specific industries.

### 3.6. Discussing the impact of increases and decreases in the money supply

The national money supply is the amount of money available for consumers to spend in the economy. In the United States, the circulation of money is managed by the Federal Reserve Bank. An increase in money supply causes interest rates to drop and makes more money available for customers to borrow from banks.

The Federal Reserve increases the money supply by buying government-backed securities, which effectively puts more money into banking institutions. An increase in paper money reduces the value of the dollar, but increases the money banks can lend to consumers. When banks have more money to loan, they reduce the interest rates consumers pay for loans, which typically increases consumer spending because money is easier to borrow. The government will request an increase in the money supply when the economy begins to slow to spur additional spending by consumers and build confidence in the economy.

An increase in money supply can also have negative effects on the economy. It causes the value of the dollar to decrease, making foreign goods more expensive and domestic goods cheaper. With the complex global economy, this can ripple out and affect other nations. Steel, automobiles, and building materials can all cost more. As a result, the prices for home building and real estate increase because of increased material and building expenses. It does make it easier for customers to get loans, however, because banks are more willing to loan money.

It is important to distinguish the cause and effect of the two variables - you are asking why a decrease in money supply leads to an increase in interest rates, and the replies have so far been telling you why an increase in interest rates leads to a decrease in money supply.

So, can you change the money supply to have an effect on interest rates? Yes. Let's see what happens.

First, you have a decrease in money supply. This is usually the result of a central bank policy (although we shall not go into how exactly they do this - might be confusing). Assuming that we

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are in the short run, prices are given (i.e. do not change) and money demand remains the same. Now, there is disequilibrium in the money market, where money demand is greater than money supply.

Keeping that in mind, we now look at the initial equilibrium interest rate,  $r^*$ . Now, at this current interest rate, people are holding less money than they desire, so they sell their assets (that pay interests) to have greater liquidity. However, as we have mentioned earlier, money demand is greater than money supply, there will be more people wanting to sell assets to obtain liquidity than people willing to buy assets and giving up liquidity.

As a result, the interest rates get pushed up slowly, so as to reflect the market mechanism of creating a greater incentive for people to hold on to / buy assets. The interest rate will then rise to a point where there are equal numbers of assets being bought / sold. At this same point, money demand would also have decreased to match the lower money supply.

In economics when interest rates increase, investment decreases and saving increase. People don't borrow money as much when there is a high interest rate, but save more. So there is a decrease in the money supply, because people aren't borrowing (aka spending) for houses, cars, etc. Economic growth occurs when people spend money, not save.

Decrease in money supply will not cause an increase in interest rate. It should be opposed. Too high money supply will cause inflation, simplify means very high price for overall product on the market. Inflation is an economic problem. When interest rate is raised, people will spend less money and save it into bank. People invest less into stock, bond since those returns are relatively low. As people spend less money in the market overall, the money supply will decrease.

### **3.7. Discussing the importance of regulating money supply of any country**

#### **Financial market regulation**

In general, financial market regulation is aimed to ensure the fair treatment of participants. Many regulations have been enacted in response to fraudulent practices. One of the key aims of regulation is to ensure business disclosure of accurate information for investment decision making. When information is disclosed only to a limited set of investors, those have major

advantages over other groups of investors. Thus regulatory framework has to provide the equal access to disclosures by companies. The recent regulations were passed

in response to large bankruptcies, overhauled corporate governance, in order to strengthen the role of auditors in overseeing accounting procedures. The Sorbanes-Oxley Act of 2002 in US was designed particularly to tighten companies' governance after dotcom bust and Enron's Bankruptcy. It had direct consequences internationally, first of all through global companies. The US Wall Street Reform and Consumer Protection Act (Dodd-Frank) of 2010 aims at imposing tighter financial regulation for the financial markets and financial intermediaries in US, in order to ensure consumer protection. This is in tune with major financial regulation system development in EU and other parts of the world.

## Self check

### Part I choose the best answers

1. The price of financial securities can be determined by

A. Market force B. court C. tax agent D. none

2. The price in the financial market should be

A. Vague B. transparent C. indefinite D. none

3. The type of financial market by which banks and other financial institutions make money by lending money to other Organizations is called

A. Money market B. Bond market C. stock market D. none

4. The market place where many commodities are traded is referred to as

A. General market B. Specialized market C. A and B D. none

5. Financial market facilitates

A. The inflow of funds B. the outflow of funds C. A and B D. none

### Give short answer

#### 1. What are the Functions of Money?

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**2. Write the characteristics of money**

\_\_\_\_\_

**3. Mention some Instruments traded on the short term money market**

\_\_\_\_\_

## Unit four:- Factors influence Ethiopian economy

This unit to provide you the necessary information regarding the following content coverage and topics:

- Explore the role and impact of global market situation and federal and regional State governments action
- Discuss the impact of a change in domestic interest rates
- Discuss the impact of changes in consumer activity

This guide will also assist you to attain the learning outcomes stated in the cover page.

Specifically, upon completion of this learning guide, you will be able to:

- Explore the role and impact of global market situation in Federal and Regional State
- Discuss the impact of a change in domestic interest rates
- Analyzed the impact of Ethiopian economy event.

## 4.1. Explore the role and impact of global market situation and federal and regional State governments' action

Global finance today is dominated by private capital flows, and private actors like your institutions play a critical role in the international financial system. I am therefore very pleased to be here today, as part of the continuous dialogue between the IMF and financial markets.

### 4.1.1. The Global Outlook

Global outlook is world in one village so information and any other communication channel is easily to get one information. Inflation remains reasonably subdued so far - the second-round effects of higher oil prices have not been significant. With monetary tightening underway in most cyclically advanced countries, inflation expectations are generally well-anchored. In addition to further increases in oil prices, however, one risk to this outlook in some countries is a significant rebound in unit labor costs as labor markets tighten, especially if productivity growth were to weaken. Further, strong foreign exchange inflows pose a challenge for monetary policy in some emerging markets - notably in Asia and the Commonwealth of Independent States. Without more exchange rate flexibility,

A downward bias remains on short-term risks. On the upside, strong corporate balance sheets and wealth effects from rising equity markets could lead to stronger than expected domestic demand. On the downside, the key risks include further exchange rate volatility, faster than expected rises in interest rates (for example, if triggered by inflationary pressures), and extended weakness in the euro area and Japan. Moreover, oil prices have recently risen above their October peaks and continue to be volatile. With excess capacity very low, the oil market remains

### 4.1.2. Prospects for global Financial Markets

Against this background of an expanding world economy, global capital markets are expected to see solid, if slowing, earnings growth. As noted earlier, there is limited inflationary pressure, balance sheets of the corporate, financial and household sectors continue to strengthen in many

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countries, and the credit quality of emerging market borrowers continues to improve. Combined, these favorable fundamentals support financial market stability. Let me go into more detail.

The overall excellent profitability of the corporate and financial sectors over the past few years has been an important factor in the strengthening of their balance sheets. The ratio of liquid assets to debt has risen and stayed at a relatively high level for some time now. So far, this preference for liquidity reflects the caution of corporate executives in making investments. This has contributed to the slow growth in employment in many countries. By the same token, this cautious attitude has helped to contain the risk of creating investment excesses in the recovery phase that, in the past, have contributed to sharp market corrections.

At the same time as financial institutions have improved their profitability, they have also strengthened their capital bases and risk management systems. In particular, solvency ratios in the insurance sectors of many countries have been improved. These developments have made financial institutions more "weather-proofed" against potential future shocks. All in all, there has been significant improvement in the health of the financial system up to the early part of 2005.

Amidst these positive developments, market volatility, mature government bond yields, and global credit spreads have remained low. Looking ahead, while there is little reason to believe that this benign scenario will end in the near future, the resilience of the global financial system could be tested by a number of factors.

First, there remains a risk for disturbances in the currency markets. Currency adjustments to address the growing global imbalances have so far been orderly. Portfolio inflows, A sharp reduction in such inflows, or a reversal, could entail serious consequences for currency and capital markets. Witness, for example, the recent episodes of market reaction to information and official statements on the diversification of central banks' international reserves.

Second, low short-term interest rates are encouraging investors to move out along the risk spectrum in their search for absolute or relative value. The search for yield has contributed to the compression of inflation and credit risk premiums and encouraged the rapid growth of structured products, including credit derivatives. The combination of compressed risk premiums, and the rapid growth of complex and leveraged instruments that lack transparency, is a potential source

of vulnerability that merits attention. There is little cushion for bad news regarding asset valuations if expectations for continued favorable fundamentals change.

Third, A continued measured withdrawal of stimulus remains appropriate, and will likely contribute to continued financial stability. However, a larger than expected spike in interest rates, resulting from inflationary pressure or a sharp reduction of foreign portfolio inflows into fixed income markets, could bring about market corrections.

Fourth, financial risk-taking, encouraged by a prolonged period of abundant liquidity, may have created very high valuations. As a result, volatility may have been pushed to very low levels across a wide range of markets. Past tightening cycles have revealed hidden vulnerabilities as the incentive to reach for yield was withdrawn. In some cases, emerging markets have experienced turbulence in the wake of tightening monetary conditions.

Fifth, Solid global growth has boosted export demand and commodity prices. Interest rates and credit spreads have remained low. With liquidity abundant, investor appetite for new issues from emerging market borrowers has been quite healthy, permitting a high level of issuance at low cost. However, as in the credit markets of mature economies, the factors contributing to low interest rates and low spreads may have peaked, and less easy financing conditions are to be expected. Underlying interest rates are set to rise, and credit spreads are more likely to widen than narrow. Of course, a widening of spreads could have the salutary effect that investors better discriminate among emerging markets according to their respective fundamentals.

It is therefore appropriate that, in response to the string of emerging market crises during the second half of the 1990's, a number of countries have strengthened efforts to develop local securities and derivatives markets. As a result, some local markets have begun to provide alternative sources of funding. These will prove particularly useful when the local banking system experiences difficulties, or when access to international capital markets is curtailed. The development of these markets is already paying off in some countries, attracting international investors searching for higher yields and diversification opportunities.

## 4.2. Discussing the impact of a change in domestic interest rates

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A change in aggregate expenditures on real production, especially those made by the household and business sectors, that results because a change in the price level alters the interest rate which then affects the cost of borrowing. This is one of three effects underlying the negative slope of the aggregate demand curve associated with a movement along the aggregate demand curve and a change in aggregate expenditures. The other two are real-balance effect and net-export effect. The interest-rate effect is one of three basic effects that indicate why aggregate expenditures are inversely related to the price level. The interest-rate effect works like this: A higher price level induces an increase in the interest rate which results in a decrease in borrowing used for consumption expenditures and investment expenditures. A lower price level has the opposite effect, inducing a decrease in the interest rate which triggers an increase in borrowing used for consumption expenditures and investment expenditures.

Before examining the details of the interest-rate effect, consider the specifics of what it does. A typical aggregate demand curve is presented in the exhibit to the right. The negative slope of the aggregate demand curve captures the inverse relation between the price level and aggregate expenditures on real production.

Most investment expenditures by the business sector and a fair amount of consumption expenditures by the household sector (especially for durable goods) are made with borrowed funds. Businesses typically borrow the funds needed for capital goods like factories and equipment. Households often borrow the funds used to buy durable goods like cars and furniture. The cost of borrowing these funds depends on the interest rate. A higher interest rate can add to the overall cost of the expenditure. A lower interest rate can reduce the overall cost of the expenditure.

This means that changes in the interest rate can have a big impact on consumption and investment spending. The interest rate tends to increase and decrease as the price level increases and decreases. This means that a higher price level induces a higher interest rate which raises the cost of borrowing and discourages investment and consumption spending. A lower price level has the opposite result.

Make note of the different role that interest rates play in a change in aggregate demand (a shift of the aggregate demand curve) and a change in aggregate expenditures (a movement along the aggregate demand curve). When interest rates change as a result of changes in the price level, the result is a change in aggregate expenditures and a movement along the aggregate demand curve. This is, in fact, the interest-rate effect. If interest rates change for any other reason (and there are many), the result is a change in aggregate demand and a shift of the aggregate demand curve. In this case, interest rates are an aggregate demand determinant.

### 4.3. Discussing the impact of changes in consumer activity

Applications for home loans

- Purchase of private health insurance
- Purchase of university education
- Purchase or building of residential accommodation
- Retail spending
- Tourism within Ethiopia by Ethiopians.

Housing's Economic Impact

Housing impacts local economies. See estimates of the jobs, income, and taxes generated from typical single family and multifamily housing projects -- reports that can be customized for your area. Also, view other useful and interesting information that has been compiled by NAHB's Housing Policy Department.

Tourism and the environment are continuously found in a relation of interdependence, as tourism is almost always dependent on the quality of the environment. Moreover, the quality of the environment or certain characteristics of it, are often a pole of attraction for tourists. Cases where traditional tourist destinations have lost their glamour (and flow of visitors) due to environmental problems are not rare

Tourism, one of the major industrial sectors occupying one in fifteen workers worldwide (Croal, 1997), with a range covering the developed and developing World, is included in the spectrum of environmental protection activities. Globally, the tourism wave was multiplied almost 25 times.

The continuing expansion of the tourist phenomenon during the last fifty years was rapid, resulting to the huge phenomenon of “mass tourism” with various consequences, one of which is the suffocating pressure to the environment, with harmful effects (Williams and Shaw, 1998). Even if most of the registered cases of the negative consequences of tourism concern the developing world, the developed world does not constitute an exception.

According to Skanavis et al. (2004), there exist two types of relationships between tourism and the environment, a symbiotic one and a competitive one. In the symbiotic relation the environment and the tourism coexist harmoniously and to an extent they complement each other. Human activities do not degrade the natural environment; on the contrary they strengthen it resulting in mutual benefit. In the competitive relation of tourism and environment, the conflict of these two is presented as economic and anthropogenic activity trying to predominate over the environment and to lead to the degradation of it through the thoughtless growth of activities. Some of the most widespread cases of negative environmental impacts due to the tourist activity are the sea quality from the marine transport, the quality of aquatic environment from the disposal of sewages, unrefined or defectively processed, the quality of land from the uncontrolled disposal of waste, the geomorphology due to extensive building and creation of infrastructure networks, the flora, fauna and generally in the natural ecosystems from the various land uses, the loss of natural ecosystems, the exhaustive fishery, the removal of fauna, due to noise pollution or deforestation, the exhaustion of available quantity of aquatic potential due to the abrupt and increased consumption combined with the reduction of permeability of grounds (UNEP, 1995).

The impacts of international tourism on natural environment are equally convergent with domestic tourism. Domestic second home tourism is considered to be more environmentally sound form of tourism than for example long-haul travelling by air, which causes remarkably higher emissions of green house gases and pollutants. Having a second home does not inevitably reduce other forms of tourism and recreational mobility, unless it substitutes them (Coenen and van Eekeren, 2003; Amposta, 2009; Skanavis & Giannoulis, 2010).

In recent years flying has become progressively cheaper, which has led to an increase in the popularity of purchasing second or even third homes in amenity rich tourist resorts far from the permanent home (Gallent et al., 2005). Mathieson and Wall (1982) underline that rural second

home development cause's clearance of vegetation, disrupts wildlife and reduces soil stability, deposition of human wastes into natural waters reduces water quality, and visibility of second homes may decrease the aesthetic value of rural landscape. Dubois (2005) draws attention to growing energy consumption, floor space and land demand of second homes.

## Self check

### Part I. Choose the best answer from the alternative

- The system that plays a key role in the economy of a country is referred to as  
A. Financial system B. financial market C. monetary system D. none
- Financial market permits the transfer of funds from one agent to another for  
A. Investment B. consumption C. A and B D. None

### PART TWO: WRITE TRUE OR FALSE ACCORDINGLY

- \_\_\_ 1. Watch dog is one of the elements of the financial system.
- \_\_\_ 2. NGO is not an actor in an economy.
- \_\_\_ 3. Financial market allows a transfer of risk from lender to borrower.
- \_\_\_ 4. Financial services are provided by financial regulator.
- \_\_\_ 5. You can act as a participant in the Ethiopian economy.

### Give short answer

1. What are the Functions of Money?
2. Write about Global Outlook.
3. Write Definition of financial regulation.
4. What are the role of financial regulators
5. Describe the role of regulators
6. Write Definition of 'Financial Market 'and Market.

## Unit Five: The role of financial regulators

This learning guide is developed to provide you the necessary information regarding the following content coverage and topics:

- Identifying Ethiopia's financial regulators and their role

This guide will also assist you to attain the learning outcomes stated in the cover page.

Specifically, upon completion of this learning guide, you will be able to:

- Identified the main regulator of the financial system
- Explained the role of each Financial regulator

## 5.1. Identifying Ethiopia's financial regulators and their role

### 5.1.1. Definition of financial regulation

Financial regulation: laws and rules that govern what financial institutions such as banks, brokers and investment companies can do. These rules are generally promulgated by government regulators or international groups to protect investors, maintain orderly markets and promote financial stability. The range of regulatory activities can include setting minimum standards for capital and conduct, making regular inspections, and investigating and prosecuting misconduct.

**Financial regulation** is a form of regulation or supervision, which subjects financial institutions to certain requirements, restrictions and guidelines, aiming to maintain the integrity of the financial system. This may be handled by either a government or non-government organization. Financial regulation has also influenced the structure of banking sectors, by decreasing borrowing costs and increasing the variety of financial products available.

The objectives of financial regulators are usually:

- **market confidence** – to maintain confidence in the financial system
- **financial stability** – contributing to the protection and enhancement of stability of the financial system
- **Consumer protection** – securing the appropriate degree of protection for consumers.
- **Reduction of financial crime** – reducing the extent to which it is possible for a regulated business to be used for a purpose connected with financial crime.

Acts empower organizations, government or non-government, to monitor activities and enforce actions. There are various setups and combinations in place for the financial regulatory structure around the global. Leaf parts are in any case:

Financial intelligence collection

FINITE does not necessarily involve money laundering, which refers to the practice of the undeclared and covert transfer of money or other negotiable item. However FINITE is used to detect money laundering, which is often done as part of or as a consequence of some other criminal activity.

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FINITE involves scrutinizing a large volume of transactional data, usually provided by banks as part of regulatory requirements. Transactions made by certain individuals or entities may be studied. Alternatively, data mining or data matching techniques may be employed to identify persons potentially engaged in a particular activity.

Where financial institutions are required to make manual reports of certain financial transactions, obtaining this information is a type of HUMINT, just as the report of military police in a combat zone is HUMINT. Not all HUMINT comes from espionage. Many industrialized countries have such reporting requirements.

It may be possible for the FINITE organization to obtain access to raw data at a financial organization. From the collection standpoint, if the data are in computer-readable format, this is a type of SIGINT. From a legal standpoint, this type of collection can be quite complex. For example, the CIA obtained access to the Society for Worldwide Interbank Financial Telecommunication (SWIFT) data streams, but this violated Belgian privacy law.

### **5.1.2. Supervision of stock exchanges**

Exchange acts ensure that trading on the exchanges is conducted in a proper manner. Most prominent the pricing process, execution and settlement of trades, direct and efficient trade monitoring.

### **5.1.3. Supervision of listed companies**

Financial regulators ensure that listed companies and market participants comply with various regulations under the trading acts. The trading acts demands that listed companies publish regular financial reports, ad hoc notifications or directors' dealings. Whereas market participants are required to publish major shareholder notifications. The objective of monitoring compliance by listed companies with their disclosure requirements is to ensure that investors have access to essential and adequate information for making an informed assessment of listed companies and their securities.

#### 5.1.4. Supervision of investment management

Asset management supervision or investment acts ensures the frictionless operation of those vehicles.

#### 5.1.5. Supervision of banks and financial services providers

Banking acts lays down rules for banks which they have to observe when they are being established and when they are carrying on their business. These rules are designed to prevent unwelcome developments that might disrupt the smooth functioning of the banking system. Thus ensuring a strong and efficient banking system

#### 5.1.6. Regulatory reliance on credit rating agencies

Think-tanks such as the World Pensions Council (WPC) have argued that most European governments pushed dogmatically for the adoption of the Basel II recommendations, adopted in 2005, transposed in European Union law through the Capital Requirements Directive (CRD), effective since 2008. In essence, they forced European banks, and, more importantly, the European Central Bank itself e.g. when gauging the solvency of based financial institutions, to rely more than ever on the standardized assessments of credit risk marketed by two private agencies- Moody's and S&P, thus using public policy and ultimately taxpayers' money to strengthen an anti-competitive duopolistic industry. Ironically, European governments have abdicated a key component of their regulatory authority in favor of a non-European, highly deregulated, private cartel

### 5.2. Promoting the role of financial regulator in investors and consumers

**Main regulator** in the financial system may include: Financial Intelligence Center

Regulation plays an important role in helping markets function effectively, and ensuring that they support wider policy goals.

- **Regulation** can also distort competition – particularly by affecting the scope for new firms to enter markets, and the ability and incentives of firms to compete with each other.

- **It is important** to identify possible unintended consequences of regulation.

Carrying out a competition assessment of new policy can help with this.

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- **To reduce distortions**, policy makers should seek to minimize regulation, subject to achieving the wider policy objective.
- **Market-based** approaches can sometimes be an effective alternative to direct regulation, harnessing markets in a way that fits with wider policy goals.

### **Financial market regulation**

In general, financial market regulation is aimed to ensure the fair treatment of participants. Many regulations have been enacted in response to fraudulent practices. One of the key aims of regulation is to ensure business disclosure of accurate information for investment decision making. When information is disclosed only to limited set of investors, those have major advantages over other groups of investors. Thus regulatory framework has to provide the equal access to disclosures by companies.

The recent regulations were passed<sup>15</sup> in response to large bankruptcies, overhauled corporate governance, in order to strengthen the role of auditors in overseeing accounting procedures. The Sorbanes-Oxley Act of 2002 in US was designed particularly to tighten companies' governance after dotcom bust and Enron's Bankruptcy. It had direct consequences internationally, first of all through global companies. The US Wall Street Reform and Consumer Protection Act (Dodd-Frank) of 2010 aims at imposing tighter financial regulation for the financial markets and financial intermediaries in US, in order to ensure consumer protection. This is in tune with major Financial regulation system development in EU and other parts of the world.

Some degree of regulation is essential for modern markets to function. Buyers and sellers need to have confidence that the contracts they sign will be upheld and that property rights are clearly defined. Regulation can have beneficial effects for society. It often provides important protection, for instance regulations that protect the health and safety of workers. Regulation also has a potentially important role in protecting consumers, for example, through licensing of approved suppliers. Regulation typically consists of a set of rules administered by the Government to influence the behavior of businesses and, consequently, economic activity.<sup>14</sup> In this sense the term 'regulation' captures a wide range of Government actions, from primary legislation setting market frameworks through to detailed regulations imposed and enforced by specialist thematic and sectoral regulators.

There are examples where distortions resulting from regulation are not negative. For example,

competition law explicitly constrains the behavior of firms in the market to ensure that consumers are not harmed by abuse of market power

## Self check

### Part I. Choose the best answer from the alternative

- Which one of financial markets in Ethiopia can include?
  - bond market
  - derivatives markets
  - foreign exchange market
  - All are answer
- Which one of structural approach, the financial system of an economy?
  - Financial markets
  - money market including the short term money market
  - options and futures markets
  - All
- The National Bank of Ethiopia was established in \_\_\_\_\_ by proclamation \_\_\_\_\_ of \_\_\_\_\_ and began operation \_\_\_\_\_ respectively.
  - 1963 by proclamation 206 of 1963, 1964
  - 1963 by proclamation 206 of 1964, 1964
  - 1963 by proclamation 260 of 1863, 1964
  - None
- The vision, mission and goals of the National Bank of Ethiopia has emanated from the overall vision of the government which is "to see.
  - To Country, where in democracy
  - To Citizens reach middle economic level"
  - To People, where in social justice
  - All are correct
- Which one of Participants in the financial markets?

- A. banks and non-banking financial institutions
- B. corporations
- C. individuals

**All Part II. Say true if the statement is correct or false if wrong**

1. Global finance today is dominated by private capital flows, and private actors
2. Money is one of the greatest inventions of a human thought.
3. The financial system plays the key role economic growth, influencing economic undeveloped of the actors.
4. Financial institutions are the key players in the financial markets
5. Global capital markets are expected to see solid, if slowing, economy growth.
6. The objectives of financial regulators are only Reduction of financial crime

**Part III. Matching from B to A the similar word**

<b>A</b>		<b>B</b>	
<b>1</b>	Insurance Companies	<b>A</b>	Treasury bill
<b>2</b>	Banks	<b>B</b>	Bond markets
<b>3</b>	Mutual Funds	<b>C</b>	Funds from the savings
<b>4</b>	Government	<b>D</b>	National Bank of Ethiopia
<b>5</b>	Government Bond Market	<b>E</b>	Certain event happens
		<b>F</b>	Deposits

**Part IV. Give short answers**

1. Describe what is meant by the Ethiopian financial markets
2. Explain the function and role of the National Bank of Ethiopia (NBE)
3. Explain Ethiopia's monetary system

#### 4. Explain the key factors that influence the Ethiopian economy

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