POST-DEVALUATION ETHIOPIAN ECONOMY: FROM STAGFLATION TO STAGFLATION

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1. INTRODUCTION

In late September 1992, the Transitional Government of Ethiopia (TGE) adopted a policy package which, according to its beliefs and hopes, are capable of relocating the economy from the inflationary depression on the trajectory of high growth in an environment of stable prices and sustainable balance of payments. Although details are missing, the essence of the reform package has close similarity to the Structural Adjustment Programs (SAPs) designed with the intellectual and financial support of the IMF and the World Bank (Fund/Bank hereafter) for implementation in a number of developing countries.

That the Ethiopian economy needed a shock therapy to reverse the depressionary trend is not in dispute. What could be controversial is the appropriateness, capacity and efficiency of the selected policy package to deliver the desired and expected results.

Our evaluation of the Fund/Bank approach to structural adjustment based on (a) examination of consistency between policy instruments and targets and within the various objectives, (b) review of experience of countries who have and are implementing similar packages, and (c) the problems and constraints of the Ethiopian economy leave us no room but to doubt the efficacy of the program.

Given our current state of knowledge, it is our expectation that: (a) the economy would be as, if not more, inflationary; (b) the current account deficit would improve at the cost of domestic capacity utilization and growth; (c) the external debts of the country would increase making their servicing difficult if not impossible; (d) the birr would be devalued further, and (e) the extent of poverty would grow in intensity, since there is nothing to trickle down to substantiate the trickle down theory, as well as in magnitude due to the contractionary nature of the policy.

Such pessimistic prognosis was arrived at after a thorough review of the theory and experience of SAPs. In particular, we derive our conclusions from: (a) the inconsistency between instruments and targets as well as between the different objectives of SAPs; (b) review of experience of countries who have and are implementing similar policy packages; and (c) reflections on the nature and constraints in the Ethiopian economy.

The rest of the paper is organized as follows. Section 2 would be a succinct presentation of the economic reform program followed by reflections on the SAP model through which these goals are to be realized in Section 3 and 4. Section 5 would be a brief review of the
problematic of the Ethiopian economy along with policy recommendations of a supplemental nature. Section 6 concludes the paper.

2. THE ECONOMIC RECOVERY PROGRAM OF TGE

Over the past decade and a half, the Ethiopian economy has persistently declined deep into serious crisis. Agriculture which is the source of livelihood for over 85% of the population and generating half of the GDP and 85% of merchandise export was virtually stagnant while population was growing at the staggering rate of 2.9% per annum. Consequently, per capita food availability now stands at only 75% of the nutritional norm.

The acute supply constraint of agricultural commodities resulted in a cascade of worsening performances in all other sectors and activities reflected in a variety of economic indicators such as the unsustainable current account deficit, soaring inflation, declining purchasing power of the currency, and increasing debt burden, among others.

That the economy should not continue on the course of downward drift and that something needed to be done to reverse the trend was obvious. It was with this intention that the TGE put together a policy package for immediate implementation. The important elements of this package include:

a) Exchange Rate Policy

The decline in the economy has been attributed both to external and internal factors. Chief among these is the overvaluation of the currency. The Birr was devalued by 142%. It is believed that this will motivate producers to increase the supply of tradeables which will therefore correct foreign trade imbalances and create conditions favorable for future economic growth. It is also argued that, as the rate of devaluation reflects the real exchange rate it will be forceful to close the gap between the official and parallel market rates and so abolish contraband trade.

b) Monetary Policy

Generally, tight monetary policy that will ensure the consistency of money expansion with low inflation, rapid economic growth and external balances, is to be pursued. This is also envisaged to minimize the crowding out effect of private investment.

c) Interest Rate

Ceilings on the rate of interest are to be lifted so as to enable it to reflect the state of the financial market. Both loans and deposit rates are to be revised upwards. A positive real deposit rate of interest is to be aimed at. It is also to be instrumental in controlling the circulation of money in the country.
d) Fiscal Policy

The need to reduce the fiscal deficit by greatly reducing expenditure while at the same time reforming the tax system so as to increase the tax base and ensure high level of collectibility is on the agenda. A system of creating government bonds and bills saleable to the public may as well be introduced.

e) Trade Liberalization

Restriction on trade entry is lifted introducing a system of open general licence. Export taxes on all commodities, except coffee, is to be abolished. Revising the tariff structure and reducing the rates are the likely steps to follow.

f) Price Deregulation

Price control on agricultural commodities is abolished. Prices of state-owned industrial products as well as services are to be determined by competitive market forces. So increasing reliance on markets and prices as efficient allocative mechanism of resources is to be the nucleus of the new economic policy.

g) Privatization and Public Enterprise Proclamation

With a view of enhancing productivity and profitability under conditions of free competition, a reorganization of public enterprises whereby they can exercise managerial autonomy is proclaimed. Privatization of public enterprises with good prospects also seems to be forthcoming.

h) Investment Law

The investment law is expected to encourage both domestic and foreign investment, thereby expanding production activities and creating employment. Absorption of foreign technology, know-how and technical skills by Ethiopian entrepreneurs is also part of the set of investment objectives.

i) Labor Law

The Draft Labor Law aims at allowing increasing scope to market forces so as to develop flexible and efficient markets. It is also expected to make enterprises profitable and efficient and thereby create more job opportunities.

j) Transport Deregulation

Zonal restriction on transport services is lifted. To improve financial performances of this sector, transport tariff rate is revised. The expected results of the policy package are the revival of economic growth, expansion of employment opportunities, stable prices and healthy balance of payments position.
3. THE THEORETICAL BASIS AND SHORTCOMINGS OF THE REFORM MODEL

3.1 Theoretical Basis

The theoretical model from which the policy package was derived is the Structural Adjustment Program (SAP) which was developed mainly (but not exclusively) at and used exclusively by the Fund and the Bank. The stated objectives of the Bank/Fund developed and supported adjustment programs are "the attainment of a viable balance of payments, satisfactory long-term growth performance, and low inflation" (Khan, 1990:195; see also Khan, Montiel and Haque, 1986). The necessity of an adjustment program sources from the divergence between aggregate supply and aggregate demand leading to balance of payment crisis and domestic inflation. If the excess demand is allowed to persist for a long time "the country would experience a widening current account deficit, a loss of international competitiveness, higher inflation, increased distortions in relative prices, a declining growth rate, and a heavier foreign debt burden" (Khan, 1990:196).

To reverse this trend and put the economy on the path of sustainable growth, a package of policy instruments are operationalized. A typical Fund/Bank adjustment program is aimed at:

a) improving the current account deficit by increasing the volume of exports and decreasing the import bill;

b) eliminating market distortions and enhancing microeconomic efficiency;

c) price stability; and

d) economic growth with minimum social cost (Killick, et al., 1984; Williamson, 1983; and World Bank, 1991).

These goals are to be realized through instruments aimed at reducing and switching domestic expenditure as well as the liberalization of the domestic and external markets.

Expenditure-reducing strategy is aimed more at stabilization and is based on monetary and fiscal variables, the most conspicuous of which are reduction in government expenditure and tight credit. These and the complementary instruments are expected to and usually succeed in suppressing aggregate demand and so reduce the current account deficit and also contain inflation.

Expenditure-switching policies have two interrelated goals: primarily to reduce the current account deficit by compressing imports and expanding exports and secondly, to restore growth in the economy initially through the full utilization of existing productive
capacity followed by increased capacity made possible through investment. These twin goals are to be consummated through:

a) Devaluation of the currency. This instrument is expected to increase the domestic currency prices of tradeables and shift resources in their favor at the expense of the non-tradeables.

b) Trade liberalization aimed at increasing the elasticities of supply of exportables, import demand and the supply of import-substituting goods. Trade liberalization requires removal of import barriers, including the replacement of quantitative restrictions by tariffs whose rates are to be reduced over time.

c) Liberalization of the domestic market to eliminate distortions, inefficiency and sectoral bias. Consequently, the goods, factor, and money and capital markets are to be deregulated.

Since the economy is to undertake these measures in the face of serious foreign exchange constraints, the international community, spearheaded by the Fund and the Bank, are expected to provide bridging finance.

3.2 Shortcomings of the Model

The SAP model is the product of attempts at synthesizing the monetary approach to the balance of payments (the preserve of the Fund) and the neoclassical theories of economic growth. Since the early eighties when it appeared on the scene, it has been vigorously and forcefully recommended as a panacea for economies in distress and implemented mainly in Latin America and Africa.

A sober review and assessment of the experiences of countries that have implemented SAP failed to indicate its claim to providing distressed economies with the only sound and foolproof means of growing out of their problems. Comparative studies among countries at the same time and the same countries over time show consistent and pronounced divergence between the promised and the actual results.

This conspicuous failure of the model stimulated interest both in academic and non-academic circles, but mainly outside the Bank, to revisit and re-examine the theoretical foundations and the transmission mechanisms envisaged. A number of explanations elucidating the inherent weaknesses of the SAP were made and suggestions forwarded to improve the efficacy of the model. Some of the recommendations (the need to provide safety nets for the disadvantaged, for example) were found acceptable to the Bank and were incorporated in later generation programs. But the fundamental shortcomings of the model manifesting themselves in inconsistencies and contradictions between and within instruments and targets have, unfortunately, not been addressed satisfactorily.
Among the explanatory factors, the following inconsistencies and contradictions inherent in the model are briefly noted:

a) **Trade Liberalization is Inconsistent with Reduction in Current Account Deficit**

Both of these are the aims of SAP. But liberalizing trade by lowering tariff and eliminating quantitative restrictions lowers the domestic price of imports, thus attenuating the domestic currency price increasing effect of devaluation. To take an extreme example, if tariff is reduced by 100% when the currency is devalued by 142%, the effective devaluation on imports would amount to 42% only. Such a relatively insignificant increase in the price of imports may not be able to reduce the demand for imports especially in those countries (like ours) where the import-substitution effect of devaluation is likely to be weak over the medium run.

b) **Tariff Reduction and Government Budget Deficit**

Important sources of government revenue in developing countries are taxes on international trade. The reduction on export duties to encourage exports combined with tariff reduction is likely to decrease government revenue. On the home front, revenue is unlikely to increase, given the structure of the economy as well as the tax-administrating capacity of the government, to make up for the shortfall. On the expenditure side, it is near to impossible to decrease outlays by a significant amount. With a marginal (if any) decrease in government expenditure, the decline in revenue is likely to exacerbate the budget equation.

c) **Government Investment and Private Investment**

Government investment, particularly on human capital development (education and health) and physical infrastructure as well as on strategically positioned industries, has a "crowding-in" effect on private sector investment. The easiest and most often observed practice of governments that are forced into reducing expenditure is to reduce capital expenditure followed by outlays for the maintenance and upkeep of existing infrastructural facilities. Such politically rational behavior are likely to damage growth since private sector investment are stifled.

d) **Devaluation and Inflation**

Devaluation is inherently inflationary. The impact is transmitted to domestic prices both directly through the higher prices of imports (consumer goods, fuel, raw materials and spare parts) as well as indirectly through the higher demand arising from the tradeable sector. The pass-through would be higher the lower the elasticity of demand for imports and import-substituting goods.
Even if devaluation improves the current account, this blessing would beget the inflationary evil through the increased money supply it makes possible, given the limitations of central banks to sterilize the impact.

A crucial result of domestic price increase is the revaluation of the real exchange rate requiring another dose of devaluation. Replays of inflation would place the economy on the path of the vicious circle of devaluation which in turn fuels the inflationary pressure.

e) **Devaluation and Increase in Output**

The inflationary impact of devaluation is accompanied and is further driven by output contraction, a point that is not disputed both by the Fund and the Bank, although their acknowledgement is for the short run only. Many channels through which devaluation reduces output are identified in the literature.

The suppression of imported intermediate and investment goods, reduced volume of credit and the accompanying high cost, the state of the depressed demand which at first leads to increased inventory and later to output reduction, the income transfer impact of devaluation from the wage-earners with high propensity to consume to owners of capital with low consumption propensity, are examples of the contractionary nature of devaluation.

f) **Devaluation and the Current Account Deficit and Growth**

The current account deficit-reducing and growth-enhancing scenario of devaluation is based on the assumption of high elasticities of exports, imports and import-substituting goods. An issue of relevance is the supply response of exports and import-substituting goods, the evidence of which is at best tenuous.

The impact of devaluation on exports depends on slack in the export sector, capacity utilization, investment (including crop expansion, diversification, gestation period), etc. While the increase in domestic currency prices are necessary, they are definitely not sufficient to increase the volume of exportables. Other factors such as investor uncertainty, expectation formation, availability of modern inputs, etc. are as, if not more, important as "getting prices right". Most importantly, the speed of response is of crucial significance. Where adjustment is not quick, the inflationary impact of devaluation undermines the real exchange rate thus invalidating the comparative advantage it is expected to enjoy.

Another factor that would affect export prices are international prices. Where the latter are depressed, the domestic currency price increase is likely to be a once-and-for-all phenomenon unless the initial devaluation is followed by another and/or policies such as subsidy or tax reduction are instituted to make up for the diminishing benefits. But subsidy and tax reduction would have implication for reducing government deficit.
The Ethiopian Economy: Problems of Adjustment

In the short to medium run, both imports and import-substituting goods are unlikely to respond to changes in prices, given the structure of the economy. If the policy succeeds in decreasing imports, this is likely to reduce capacity utilization and therefore output and growth. Thus the decrease in current account deficit would be at the cost of the growth of the economy.

g) Credit Contraction Financial Liberalization, Output Expansion and Investment

Financial liberalization is designed to liberate the money and capital markets from administrative control. Since the early 1970s, administrative control of interest rates and credit management have been condemned not only for repressing the development of the financial market but also for the misuse of financial resources. In effect, this lets the interest rate to be determined by the market and the volume of credit to adjust to demand.

But the SAP model not only requires financial market liberalization but also credit contraction as one means of eliminating the monetary overhang. The combination of these two measures is to push up the interest rate. In other words, the credit market is to clear not through increase in supply but increase in price.

What would be the impact of higher interest rates on capacity utilization and investment? The immediate impact would be to increase costs which may lead to either more inflation or reduced capacity utilization. The resource mobilization capacity of interest rates is at best thin while its impact on cost of production and investment is obvious. It is not uncommon to have interest rates in high double and even triple digits. Interest rates in the range of 30 or 40 per cent would discourage use of resources in productive activities, whether own funds (because of the high opportunity cost) or borrowed.

4. PERFORMANCE INDICATORS IN STRUCTURAL ADJUSTMENT

The application of SAP to an economy that is in distress requires continuous surveillance and follow-up to see how it responds to policy stimuli. If the economy is not responding to the stimuli as expected, it would be necessary to revisit the logic, nature and magnitude of the instruments used.

Unfortunately, the performance indicators of interest to the Bank and the Fund are the suggested instruments and the magnitudes they are to assume in the course of SAP rather than the behavior of the economy. If the economy fails to turn up as expected, the fault is deemed to lie not in SAP but in the magnitude and intensity of the instruments. If the current account deficit worsens, it is because you have not devalued enough. If domestic inflation does not subside, it is because the volume of credit and government expenditure has not been reduced enough, etc.
This approach to economic management does not and had not augured well for economies attempting to adjust through SAP. Country after country has tried it, only to abandon it. But this poses a dilemma. You cannot abandon it because you need a clear bill of health from the Bank or the Fund to mobilize resources externally. But then SAP does not help straighten out your economy. It is a case of damned if you do, and damned if you don't.

Rather, the better and rational approach should have been the development of a growth-oriented program accompanied by careful selection of policy instruments and their fine-tuning to fit the exact conditions. The nature of the instruments and their magnitude and potency could be reviewed through intermediate targets and revised if and when necessary. This in fact is part of the new International Economic Order which is strenuously objected to by, among others, the Breton Woods institutions for mysterious reasons.

5. THE LIKELY PATH OF THE POST-DEVALUATION ETHIOPIAN ECONOMY

As pointed out earlier, the unknowns in the SAP adopted by the TGE are details of the policy. The exchange rate was devalued by 142% and the central bank is to pursue tight monetary policy. Interest rates are to increase so that the real rate is positive. The goods market has been liberalized along with the factor market (with the exception of land). There is a strong suggestion of rolling back the state and reducing government expenditure. Trade is to be liberalized. Quantitative restrictions are to give way to tariffs that have begun to be trimmed.

These are similar in content with Bank/Fund initiated SAP which were summarized earlier. It is interesting to speculate on the likely outcome of these set of policies. But given the conflicts among the declared objectives and inconsistencies within the selected instruments, we have no option but apprehension about the results which aim at reviving the economy through the elimination of excess demand. The essential weakness of the economic recovery program is its failure so to properly address the supply side of the economy. "Getting prices right" is a more in the right direction, but and unless it is accompanied by supply-enhancing policies, the result, we are afraid, will be increasing inflation.

In the Ethiopian context inflation is high and the balance of payments is unsustainable. These are definite consequences of excess demand. The SAP of the TGE is aimed at attaining the equilibrium of demand and supply by essentially squeezing the former.

But this is a wrong approach and would only result in driving the economy into further depression. The excess demand that has been driving both inflation and the current account deficit is not due to excessive increase in the money income of the Ethiopian people. On the contrary, the freeze or a below-the-rate-of-inflation increase in salaries and wages as well as the fixed producer prices have depressed the money income over the last two decades. Real income has continuously been declining for the last decade and a half. The excess demand evidenced in the economy is due to insufficient domestic supply. In such an environment, further depression of demand through higher prices is unlikely to be a solution to the problem.
The correct approach is one designed to increase supply. While "getting prices right" is one prerequisite, it is clearly insufficient to increase output. In the foreseeable future, the increase in output would overwhelmingly depend on the agricultural sector. Apart from the limited capacity of farmers to respond to higher producer prices because of structural rigidities and absence of supply of adequate inputs, the time element is a considerable factor of marginalizing the expected increase in output at least in the short to medium run. After a thorough review of experiences in countries attempting to adjust through programs developed by it, the IMF concluded that "If, for example, a country is a primary producer, then a change in relative prices brought about through, say, an exchange rate change, may only affect supply after a considerable lag" (IMF, 1987). In the meanwhile, the relative price advantage would have been dissipated by inflation.

A supply-oriented policy of the type we envisage is primarily based on the partnership between government and the private sector. We are appreciative of the investment policy and the liberalization of the domestic economy. We are, however, wary of the rolling back of the state in a peasant society where a private sector capable of dynamizing the economy has yet to be created. Talk of the overextension of the state needs to be revised. The state was overextended in the past in its defense build-up. In other areas, the government has been practicing extreme austerity. Its capacity to provide a minimum of essential services (water, power, education, health, maintenance of infrastructure, etc.) have been eroded.

The government must provide not only political but also economic leadership to the people. It must expand infrastructure and human capital. Above and beyond this, it must invest in strategically positioned industries and help to create both backward and forward linkages. We see no problem with ownership but in management. Given an autonomous management, we have faith in the outcome. Ethiopian Airlines is an example from the home front as are successful corporations world-wide where those who own them (share owners) are not managers.

While the deregulation of the goods market is a step in the right direction, the laissez faire nature is a disturbing one. No government in the world trusts the direction and tempo of national development to the vagaries of an unmanaged market. It is usually directed and bent to achieve a national objective articulated from the visions of leaders and the longer-term needs of the society. To this end, the government defines medium- and long-term objectives, develops the strategy and provides incentives to the private sector to influence their investment decisions. Detailed and selective intervention is necessary.

The money and capital markets should not be constrained, and in the interest of suppressing demand. Rather the policy should be designed to help achieve the revival of the economy by making financial resources available to enhance efforts to increase supply. The control and the cost of credit should be purpose-based. Bankable investments in the productive sectors of the economy and exports should be encouraged. Above all venture capital should be made available to enterprising Ethiopians who have the capacity to generate ideas and yet lack the financial means to translate these into producing entities.
The National Bank of Ethiopia should begin to resurrect the capital and money markets. A good beginning is the government's proposal of privatization of public enterprises.

We would want to see the government, as part of its efforts directed towards the creation and development of the private sector, establish an industrial technology design center along with an iron and steel complex and a petrochemical industry. Such basic activities would provide the means through which ideas are translated into designs and are transformed into physical entities using inputs provided by the steel and chemical complex. The primary importance of such centers springs from the need to start developing the manufacturing of capital goods and spare parts.

The alternative to the development of basic industrial infrastructure of the type suggested above is to continue on the traditional path of importing machinery and spare parts. In a way this approach is dangerous in the sense that the development of the economy would always be held hostage to the nation's capacity to generate foreign exchange as evidenced by the experience of the last two years.

In the interest of improving efficiency, domestic products are to be exposed to international competition. We believe that the consequence of such policy would be the industrialization of the country. To ensure survival, domestic industries need to be protected from external competition. Competition and efficiency could be forced on enterprises by encouraging them through appropriate incentives to export their products. The incentives could be in the form of the provision of easy and subsidized credit, priority in foreign exchange allocations, exemptions from export taxes and import duties. Such transfer of the competitive field from the national to the international arena would at least ensure their survival.

There is an additional reason justifying high import duties in the form of balance of payments and government revenue. Given the fact of low elasticity of imports, the post-devaluation import bill would decrease only at the cost of capacity utilization, investment and welfare. The prospect for increased volume of exports, and therefore higher foreign exchange earnings, does not seem to be bright in the short to medium run.

Consider for example, the traditional exports, hides and skins and coffee. The prospects here are not promising both in the short and medium run. Hides and skins are byproducts and depend on the demand for meat - both at home and abroad. The home demand for meat is likely to decrease given the inflationary nature of the economy. The external market was not that impressive. While the most likely direction is for volume to decrease, our hope is that it would maintain its current earning power.

What is the prospect for coffee? The international price has not been auspicious in recent years. The impact of devaluation and the minimum producer price on supply is not exciting in the short to medium run because of its gestation period which, at the minimum, extends over three years. Second and most importantly, the expected increase can materialize only if we assume farmers' price expectations to run ahead of four years or more. Given the host
of uncertainties overhanging in the production process of such perennial crops and the experience of farmers regarding price volatility, such an assumption is an overstretched one.

In the short run, the hope for increased supply of coffee is based on a very thin argument that the risk involved in illegal smuggling outweighs the gain from the small margin between the parallel market rate and the official rate, assuming of course that the parallel rate will not increase further. Given the political instability and corrupt and inadequate system of control, even if the parallel rate is not assumed to increase further significantly, there is still enough margin to encourage illegal smuggling activities. We believe the hope of diverting supply from the unofficial to the official market is too thin to materialize.

As for other exportables such as cereals, oilseeds, pulses, vegetables, etc., short- to medium-run prospects are bright for two reasons. First is the relatively high domestic home consumption. Secondly, these products could also regain their previous role in providing foreign exchange. But again while "getting prices right" is a prerequisite, other factors such as availability of inputs, etc. must also turn auspicious.

In the final analysis, the revival of the Ethiopian economy would depend upon the recovery of the agricultural sector. Not only is the rehabilitation of this sector necessary to repair the welfare of 85% of the population, the fate of the remaining 15% is inextricably tied to its performance. In short, it is the rehabilitation of the agricultural sector that will result in growth, employment, stable prices and sustainable balance of payments. Consequently, it should form the nucleus of the economic recovery program and, from a broader perspective, the rehabilitation of the economy would, in the short run, depend on investment both by the government and the private sector, most importantly the peasant. Public investment would of necessity be directed to maintenance and rehabilitation of existing but deteriorating productive capacity and infrastructure rather than in additional capacity.

Private sector investment is to be encouraged as a major prerequisite, and the government must create conducive environment and remove all causes for investor uncertainty. The issue of land must be decided upon once and for all. The relationship between the central and regional governments as well as the rules and regulations governing economic activity including fiscal policy, labor mobility, language and security must be resolved in a way that is satisfactory to investors, whether domestic or foreign.

6. CONCLUSION

In this paper we have considered the development options available to the country. Our treatment ranged from the summary of the economic recovery program, identified this with the SAP of the Bank and the Fund and outlined its weaknesses in terms of its internal contradictions and inconsistencies.

Application of the SAP to rehabilitate the Ethiopian economy, we believe, is wrong. The problem is supply constraint rather than excessive demand expansion. It is our view that
without supply-enhancing policies centered on agriculture, the economy would remain entangled in the stagflation of the past few years.

REFERENCES


