Ethiopia’s Reforms and Export Performance

In theory, devaluation promotes exports and aggregate economic activity through the famous “multiplier effect.” However, currency devaluation may not produce the desired outcomes for several reasons:

First, the Marshall-Learner (ML) condition may not hold in the short run. The ML condition is a theoretical viewpoint that links exchange rate fluctuations and trade performance from the perspective of elasticity. According to this theory, ceteris paribus, a country will improve its current account deficit by devaluing its currency provided that the sum (in absolute value) of the elasticity of demand for its exports and imports is greater than one. But most empirical results show that short run elasticities are smaller than their long run counterparts and countries may not achieve increased employment, investment and output following devaluation.

Second, if we allow for changes in some variables, such as changes in the national income, devaluation will improve the trade balance only if the improvement in trade balance generated by currency depreciation more than offsets the improvement in imports brought about by a rise in the national income. This is called the Lausen-Metzler effect.

Third, the so called J-curve effect may dilute the immediate benefits from devaluation for two major reasons: a) even if the ML condition held, export receipts may not increase in the short-run due to supply side constraints associated with time lags, which is largely the case for agricultural commodities that need several months to harvest; b) most imports are less responsive, if not, non-responsive at all despite the increase in their prices after devaluation. This applies to most capital goods and raw materials (such as oil) that have inelastic demand in capital-deficient and oil importing countries such as Ethiopia. As a result, the fall in foreign spending on the country’s exports and the increase in domestic spending on imports will cause the trade deficit to get worse before it improves, which makes the trade balance curve assume the shape of letter “J.”

The empirical evidence on the relationship between devaluation and export performance is generally mixed with the conclusions differing depending on the nature of the economies investigated, the type of methodology employed, and/or the sample size and data frequency used in the specific study.

On the flip side, therefore, devaluation may make imports less attractive leading to increased spending by domestic consumers and investors as measured by domestic currency. Moreover, inflationary infection induced by currency depreciation could eat up the potential gains from nominal devaluation. A number of studies have shown that changes in nominal devaluation entail massive increase in the prices of goods and services, thereby diminishing the international competitiveness of the economy. In other words, nominal devaluation results in real devaluation and effectively improves a country’s trade performance only if we have net positive change after adjustment in the price levels.
Still even more interesting is the impact of devaluation on income re-distribution. According to Paul Krugman and Lance Taylor (1997), even when devaluation does not affect the country’s terms of trade, it, however, could entail a number of income effects. To this effect, they have identified three major channels through which devaluation could possibly redistribute income among various economic actors:

Firstly, when the devaluation measure is undertaken in an environment where trade deficit prevails, the increase in the prices of traded goods are immediately followed by a reduction in real domestic income and by a corresponding rise abroad, since export receipts of the devaluing country are overwhelmed by its swelling expenditures on imported items. Thus, the value of the home country’s ‘foreign savings’ rise ex ante, while aggregate demand falls ex post, and imports decline along with it. The bigger the initial trade deficit, the more pronounced the contractionary effects.

Secondly, even if the country had balanced trade initially, the prices of traded goods increase relative to domestic goods following devaluation, resulting in windfall profits and rents for businesses and investors engaged in export and import-competing industries. If wages are rigid in the short run and if the marginal propensity to save from profits exceeds the one from wages, ex ante national savings rise. The magnitude of the resulting contraction is a function of the difference in savings propensities between wage earners and businesses specializing in exports and import-competing industries.

Finally, devaluation can also affect the fiscal position of the national government. Particularly, assuming that budget was initially unbalanced, the government can raise substantial additional money if there are progressive taxes on income as well as if taxes on profits are higher than taxes on wages. Moreover, if exports or imports are subject to ad valorem taxes, devaluation generates redistribution of income from the private sector to the state coffers, whose saving propensity is unity in the short run. Once again, the final outcome is reduction in aggregate demand.

Haughton and Kinh (2003), based on disaggregated household income and expenditure data for Vietnam found that devaluation of dong has modest effect on redistribution in favour of the poor and the rich while the middle class was a net loser. Acharya (2010) investigates the impact of devaluation on the Nepalese economy by applying general equilibrium model and finds that while devaluation is expansionary most of the benefits, however, accrue to the rich, thereby creating unequal income distribution. He attributes this pro-rich growth to the fact that returns to high-skilled labour and capital grow faster than returns to their low-skilled counterparts. Moreover, while the expansion was more concentrated in agricultural and industrial activities, the service sector actually suffered contraction following devaluation.

While much of the redistribution literature focuses on income transfer between domestic agents (workers, firms and governments), the income transfer could also assume international dimension. Ciuriak (2010) in diagnosing the demand and supply side constraints affecting Ethiopia’s export performance observes that market structure may also diminish the positive impact of devaluation, working in favour of few omnipotent global firms that dominate
international commodity markets. He notes that international commodity markets where developing countries sell their products are dominated by a handful of buyers with considerable power of influence that enables them to amass enormous profits and rents. Thus, such asymmetric power of influence will likely create a situation whereby the devaluation measure will boost the profits of multinational buyers with little of the benefit trickling down to the Ethiopian producers.

Reforms and Exports

In May 1991, the Ethiopian landscape was markedly overwhelmed by major economic and political changes. The military junta that terrorized the country for 17 years collapsed and a coalition of liberation fronts assumed political power. Extremely delighted with and motivated by the fall of the communist regime in the country, delegates of Western governments and institutions hurried to the capital Addis Ababa to sell their free market economic policies toolkits, packaged as Structural Adjustment Programmes (SAP), sponsored by the International Monetary Fund (IMF) and the World Bank (WB). Though deeply communist themselves, the new leaders, desperately in need of resources and foreign exchange, were easily persuaded to undertake the proposed economic reforms in exchange for low interest loans and development aid.

Under the new reform program, foreign trade and exchange rate regimes were liberalized; prices of domestic inputs and finished goods were decoupled from arbitrary government regulation and interference; public sector reform that accorded autonomy to the state owned enterprises (SOEs) was implemented; some enterprises were privatized; the financial market was reformed to allow private sector participation in commercial banking, insurance and micro credit services; export tariffs were abolished; export subsidies to domestic, export-oriented firms were eliminated and were replaced by incentives that provided the duty-free importation of raw materials.

Most important, in October 1992, Ethiopia’s national currency, the Birr, saw a major free fall when it was devalued by 242% from its pegged rate of 2.07 per US dollar to 5 per US dollar, signalling the first major onslaught on the value of Birr which since then has been virtually in a slippery slope. The authorities defended and justified such massive, one-time devaluation by pointing to the high premium on the parallel market which was close to 238% on the eve of the devaluation measure.

In May 1993, the transitional government also introduced a ‘Ducth auction’ system for foreign exchange with the objective of liberalizing the foreign exchange market. The auction system operated side by side with the official exchange rate until the two were finally unified in July 1995. Before the unification, the dual-exchange rate regime was maintained by an amalgam of government decree (relevant for the official rate) and quasi-market mechanism (which applied to the auction rate).

It was expected that the new devaluation measure would enhance domestic production and employment; eliminate the gap between the official and the parallel market rates, and improve
the country’s foreign reserves by minimizing illegal trade in smuggled goods and by re-directing much of the unofficial remittance flow towards official intermediaries.

Though still fragile and vulnerable to the vagaries of nature and aid money, the export sector in Ethiopia has shown tangible improvements since the country abandoned the fixed exchange rate regime in 1991 and implemented a series of macroeconomic stabilization and adjustment programmes.

For instance, real export receipts have increased fivefold between 1992 and 2009. The export industry has also seen significant diversification away from its dependence on coffee. In 1991, when the reform package was launched, coffee brought more than 55% of the country’s total export revenue but by the end of 2009 its share declined to less than 35% while the shares of other goods such as chat, flower, leather and leather products have increased substantially. The flower industry represents the major success story, whose share registered remarkable growth from less than 1% at the beginning of the 2000s to about 10% a decade later. Though much of this diversification is within the same industry, the overall result shows a significant departure from the traditional, mono-crop dominated export sector.

Another way of assessing the performance of Ethiopia’s export industry is to look at the employment figures that the export sector generates, particularly in agriculture where almost 90% of the country’s exportable commodities come from. Because data on export sector employment for Ethiopia is unavailable, I make a back-of-the-envelope calculation to arrive at the number of jobs created each year. To do so, first I calculated the GDP per worker by dividing the real gross domestic product by the size of the work force, where I assume the annual unemployment and underemployment rate to be 20%. The GDP per worker gives the average annual income that supports the employment of a single worker. Then to find out the number of jobs created by the export sector, I divide the annual export value by the corresponding average worker’s income.

For example, in 1981 the GDP and export value of Ethiopia measured in 2000 constant dollar were 5.147 billion and 389 million respectively, while the estimated number of workers for that year was 12.8 million. So the GDP per worker in 1981 was about 402 dollars. If we divide the value of export by 402, we get the number of jobs in export-oriented activities (coffee plantation, brokering, transportation, etc.), which was roughly 967, 400. Following this line of reasoning, we would find that the number of jobs in 2009 stood at around 3 million, which is a 200% increase compared with the level of export sector employment in 1981.

<table>
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<tr>
<th>Period</th>
<th>Export Growth (%)</th>
<th>Export Sector Job Growth (%)</th>
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<tbody>
<tr>
<td>1982-1986</td>
<td>23.57</td>
<td>19.25</td>
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<tr>
<td>1992-1996</td>
<td>106.39</td>
<td>94.92</td>
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<tr>
<td>1997-2001</td>
<td>17.27</td>
<td>12.42</td>
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<tr>
<td>2002-2006</td>
<td>94.73</td>
<td>74.55</td>
</tr>
<tr>
<td>2007-2009</td>
<td>48.88</td>
<td>22.11</td>
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Table 1 above shows the five year cumulative growth rates in export earnings and export sector employment generation for the period 1982-2009. Particularly interesting is the continuous decline in export growth and employment during the five years (1987-1991) preceding the downfall of the military junta, a period characterized by heightened conflict, uncertainty, massive defense spending and impulsive resettlement and villagization programmes following the 1984/85 famine. During this period, overall exports and export-oriented jobs shrank by 67% and 62% respectively. Moreover, though cumulative growth rates are still positive, we observe simultaneous drop in both exports and export sector jobs in the period 1997-2001 (a time period flanked by the costly Ethio-Eritrean border conflict) and 2007-2009 (due to the impact of the Great Recession that started in mid 2008). Not surprisingly, the most dramatic improvements occurred in the two five-year periods following the end of the civil war (1991/92) and the termination of the border conflict with Eritrea.

**Empirical Evidence**

Now the key question is, how much of this improvement in export growth and export sector employment can be attributed to exchange rate reforms? Does devaluation always enhance export performance, domestic production and overall national welfare?

In order to answer these questions, I conducted an empirical test to examine whether or not devaluation encourages export growth by applying Generalized Method of Moments estimators (econometric technique) on time series data covering the period between 1981 and 2009. A conventional export demand equation was formulated and estimated in which export growth is explained by real exchange rate, imports and world per capita income. The findings?

The coefficient on the real exchange rate was positive (0.09) but it turned out to be statistically insignificant, indicating that changes in exchange rate have little or no effect on Ethiopia’s export growth.

Like real exchange rate, imports do not directly impact export performance which could be due to the fact that the country’s export portfolio is composed of mostly agricultural goods that depend more on cheap and surplus labour than on expensive imported capital. It could also be due to the fact that a large proportion of the country’s imports comprise non-durable consumer goods most of which could be produced domestically. This implies that the country’s limited foreign reserves which could have been spent on productive capital goods are wasted on low-tech consumption items (such as biscuits and orange juice) that could be supplied by homegrown firms. According to the National Bank of Ethiopia, in the first quarter of fiscal year 2009/10, such consumer goods accounted for nearly 20 percent of the country’s total import bill.

Interestingly, only world income was found to positively impact export performance in Ethiopia. The findings reveal that a 1% rate of increase in world income induces about 9% rate of increase in world demand for Ethiopia’s exports and this was statistically significant at 5% level of significance.
Conclusion and Recommendations

Ethiopia’s export sector has shown certain signs of improvement since 1991 despite the continued worsening in its current account balance. While exports and export sector jobs have increased fivefold and threefold respectively, it is possible that those poor Ethiopians engaged in labour intensive, tradable goods sector have benefited from increased export of goods and new market opportunities. But unlike the widely held view, whatever improvement was recorded in export growth, there is no evidence that this improvement is due to exchange rate reforms. Particularly, the coefficient on the real exchange rate was insignificant suggesting that real devaluation or overvaluation of Ethiopia’s currency, Birr, has no discernible association with trends in the country’s export receipts.

The most important policy implication of this study is that a developing country like Ethiopia cannot revolutionize its export industry through exchange rate manipulation.

Even when domestic and external circumstances call for devaluation measures, such measures will facilitate export growth and enhance aggregate economic activity when they are accompanied by conservative monetary policies and fiscal restraints.

In contrast, post-reform Ethiopia has seen consistent increase in budget deficits along with massively accommodative monetary policies. While much of the foreign expenditure shortfalls have been covered with international loans and grants, the Central Bank of Ethiopia has been the last resort to cover domestic expenditure shortfalls.

For instance, broad money supply increased, on average, by 11.4% annually between 1961 and 1974. The average broad money expansion during the military regime (1974-1991) was only slightly higher (12.4%), which is essentially marginal, especially in light of the seemingly incessant civil war and the huge government defense spending which financed that war. But the post-reform period, and particularly the period immediately after the conclusion of the Ethio-Eritrean border conflict (1998-2000) has seen enormous increase in “quantitative easing” with average broad money growth of over 17% between 2001/02 and 2009. Thus, not surprisingly, devaluation and inflation spirals went hand-in-hand from 2002 onwards.

Moreover, on top of the need for credible and predictable monetary policy and prudent fiscal management, concerted efforts should be directed towards expanding and raising the quality of physical and institutional infrastructures. For instance, poor transport infrastructure networks increase the cost of trade and reduce the country’s international competitiveness while poor institutions (bureaucratic morass, rampant corruption, lack of transparency in public resource management and contract, etc.) raise the costs of starting business, discourage creative entrepreneurship, and thwart private sector development, which are the engine of economic growth and prosperity for any economy.

In addition to poorly developed transportation and communication networks, lack of maritime access has been another factor impeding the growth of the export industry in Ethiopia. The state of being landlocked has been costing the country nearly 1 billion dollars annually in port
fees and charges, a staggering amount which is almost equal to the country’s annual export earnings these days. Unless the political leadership takes the issue of port services seriously and champion for Ethiopia’s rightful access to the sea based on international law, the country will continue to hemorrhage huge amount of hard currency, a situation which will continue to dampen the prospect of its export led/supported growth strategy.

The recommendations provided in here concur with the findings of a recent study by Dan Ciuriak (2010) which investigated the demand and supply side constraints affecting Ethiopia’s export industry. Ciuriak identifies a number of domestic and regional factors that hamper the country’s export growth, among which the most important ones included inappropriate macroeconomic policy mix, extremely prohibitive costs in trade administration (such as the lack of access to the sea and the high costs of port service and massive fees for cargo transportation); inefficient producer services (such as finance, transportation and communication); cumbersome customs procedures; high business concentration, huge costs of entry and fragile and poorly developed private sector.

Furthermore, Seid Hassen (2010), following the surprise 16% devaluation of Birr against the US dollar on September 1, 2010, has written extensively on how recurrent devaluation could not solve many of the longstanding structural problems associated with the country’s limited capacity of domestic production. In his explanation he underscored the malignant consequences of the numerous party-owned-and-operated business companies that stifle competition and hinder the development of a vibrant private sector-led economy. He further emphasized Ethiopia will not be able to gain competitive edge and devaluation will not be a magic potion for the structural (political and economic) problems of the country and the continuous manipulation of the Birr will unlikely correct the general economic malaise.

Therefore, many of the impediments to Ethiopia’s export growth are institutional and structural and need to be assessed and addressed within the wider context of its geographic location, lack of access to the sea, slow pace of regional integration and limited market opportunities for its products, as well as its poor technological progress and increased dependence on agricultural commodities which are vulnerable to wide price fluctuations, etc.

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