# Credible policies delivering on inflation targets

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It is official. Finally the long sought after single digit inflation figure looks to be just around the corner. Indeed, the headline inflation rate for February 2013 shows that the double-digit inflation nightmare might just be counting its last days in Ethiopian economy. As per the computation of the Central statistical Agency (CSA), the rate of consumer price inflation for February in comparison to the same month last year has shown a 10.3 percent rise. What is more interesting is that what used to be a major driving force behind the consumer price inflation in Ethiopia-food price inflation- was the first to retire back to the single-digit target. For the period stated above, average food price inflated only by 7.9 percent, while its non-food counterpart stayed as high as 14.3 percent.

The estimation technique employed by the CSA puts food first on the list of the households' expenditure in the country. In fact, food expenditure accounts for 57 percent of the overall consumer budget in a given amount of time, and hence the slightest of variation in this category could have strong implications on the headline rate.

The downward trend in the inflationary pressure however started to be felt just around the close of 2012. The dawn of 2013 was then a time that saw a significant change in the inflation figure and the trajectory that it would take; at least for the near future. In January, the rates registered another low level compared with the periods that passed before it. However, 12.9 percent headline rate was not taken as a sign of order in the macroeconomic space of the nation, an attribute that the Ethiopian economy is said to have lacked in recent years. And still some commentators did not buy into the feasibility of single-digit inflation in the short and medium future.

**What has been**

Nevertheless, critics do have a rich set of data to doubt government's optimism regarding the single-digit inflation target. It is now five years since a single-digit inflation rate started to seem like a very hard target to meet. The whole ordeal of the recent macroeconomic troubles for Ethiopia started at the same time with the first round of the world financial crisis - 2007/08. But, this is not to mean that the latter is responsible for the macro malaise in Ethiopia as there is no evidence to support the claim and pundits' view also lacked any meaningful consensus on the issue. Anyway, what can be said for sure is that the resultant explosion in the price of agricultural commodities and the price of minerals, petroleum to be exact, in the international market did have an impact on local consumer prices.

Evidently, the consumer price data compiled by CSA shows that during the fiscal year from July 2007 to June 2008 average headline inflation stayed as high as 25 percent followed by another inflationary year (2008-2009), which registered 38.7 percent. The two years were by far the earliest experience that the Ethiopian economy had with its current nemesis - inflation. The debate and policy directions at the time were also good indicatives of an encounter with a new economic problem. The inflation was not to persist in fact. As the year 2010 approached, headline inflation figure started to decline mainly due to the strong pull factor from the side of food price inflation. In fact, food prices deflated on average for the fiscal year July 2009 to June 2010 at -5 percent, while the headline rate stayed timid at 3 percent for the period. The victory too was a short-lived one.

Right after the start of the new budget year, around June 2010, the fragile consumer prices started to appreciate again; and this time round, the rise was not as modest as it was in previous years. Up until September 2010, the rise was not that threatening either. Then came an unfortunate measure in the context of inflation but rather an overdue and necessary one otherwise - devaluation of the Birr against the dollar. On September 2010, the central bank of Ethiopia devalued the local currency from 13.70 to 16.30 against the dollar, a move equal to a foreign exchange shock, according to pundits. Leaving the rationale and details of the implication of the measures aside, in October, the headline inflation climbed back to 10.6 percent.

This trend was to continue up until the end of 2012, but the jump from 16.5 to 25 percent in just one month, from February to March 2011, was by far the most erratic price movement that put the country's macroeconomic stability at jeopardy. Further down the road, the rate seemed unflinching touching the 40 percent mark at end of 2012.

It is in this background that consumer price inflation in Ethiopia attained the level of one of the most discussed and digested topics over the course of the last five years.

## Locating the source

As the inflation saga unfolded since 2007/08, the debate surrounding the problem and the possible solution to bring it under control also intensified across the country. Experts and politicians deliberated on the depth of the issue and what could be taken as corrective measure. Interestingly, the bulk of the discussion was on the very sources of the inflationary phenomenon. The explanations given by some pundits and most of the opposition camp tend to concentrate on singling out one or few factors as basic causes. Meanwhile the government focused more on detailing a range of possible factors for the problem. It should also be noted that the possible explanations thrown to the idea market by each stakeholder evolved with time.

For the purpose of this analysis that is to assess the role of government's policies for the current disinflationary (declining inflation) trend triggered in the economy, it is not necessary to scrutinize all alternative explanations and arguments as to what was the cause of inflation in Ethiopia. Rather it will suffice to review the policymakers' understanding of the problem and subsequent solutions proposed and put into effect. Nevertheless, official views as well evolved across time while staying the same in their basic formulation. The former Prime Minister Meles Zenawi was obviously one common face in the frequent inflation debate platform.

All in all, official explanations to what caused the inflation can be divided into two distinct directions. One was a range of factors that are endogenous in nature, and that can be influenced and corrected via the policy measures at the government's disposal. While on the other hand, the inflation phenomenon was also caused by external market factors, which are not within the policy reach of the authorities.

As far as the external factors are concerned, the periodical price hike in the global markets on some of the most essential import goods was frequently cited by Meles as one of the culprits behind the persistent consumer price inflation in the domestic market. Of course, petroleum was number one in this category. Yet again, for the interest of this piece, focus should be on other factors that can be influenced and possibly have been already to bring down the rate to 10.3 percent.

**Demand side factor**

As the practical definition for consumer price inflation goes, all things being equal, inflation is a phenomenon where the demand for goods and services could not be met by the current level of supply in the market. So, one of the official explanations was that inflation was triggered by the gap between demand and supply in the country.

But, if supply is short of demand, as it is the case in many of the developing countries why would inflation be a double-digit problem now and has not been so thus far, one could ask? The standard argument here is that the level of aggregate demand has expanded far larger than its supply counterpart due to the phenomenon of double-digit growth in the past few years. The basic reasoning is that as economies grow, the amount of disposable income, which in turn defines the size of households' budget for consumption, would also tend to rise, albeit at different speed. As income, hence the consumption demand, increases through time, the economy should respond by availing more products to the market thereby closing the gap. Unfortunately, supply in developing markets is not that automatic to respond to such situations. In fact, supply tends to lag in following suit the changes in demand thereby creating momentary imbalance.

From a different angle, what growth entails is either more employment opportunity for the part of the labor force which was unemployed in the past or increase in the level of employment gains like wages and salaries to workers already employed. So, workers with extra money in their hand would go out to the market in search of goods and services. Here, the speed that consumers with the additional income can conquer a market and the speed that a producer responds with additional output are very different. This would lead to a temporary hike in price of consumer goods and inflation by extension.

**Supply side factors**

Indeed, Ethiopia's economy has been plagued by wide gap between the demand and supply of goods and services, for years. However, on top of the traditional gap, initial dynamics of economic growth in the country have resulted in further widening of this gap worsening the conditions of inflation. According to Meles, there is no quick fix for the problem; rather a sustainable economic growth that would eventually reward the market with ample supply is the only way out.

Nevertheless, this was not to say that there were no supply side rigidities which have played a role in the inflation saga. In fact, later in 2011, the government finally noticed that apart from the shortage of products in the market, there were also factors which blocked it from reaching the consumers. In fact, the authorities identified that the matter is not a mere market deficiency but an intentional plot by very few bigwigs in the wholesale market to manipulate prices in their favor. The late PM said on different occasions that oligopolistic like cartel arrangements are pushing market prices higher every day and propelling inflationary pressure. The authorities sound convinced that such cartels do have dangerous web of networks that extend from importers to wholesalers and retailers; and the consumer is at their mercy.

Another supply side factor that was pinpointed by the officials as one cause of inflation was the level of money supply in the market. In all fairness, this factor gained official recognition only recently. For quite a long time, the level of money supply as possible sources of inflationary pressure in the economy did not carry any weight for authorities. Nevertheless, after a rare improvement in the country's current account balance following a decline in the import bill and satisfactory export performance, in 2011, official statements indicated that the supply of money can be one factor putting pressure on price levels.

The idea of money supply as possible source of inflation emanates from the construct that fiat (paper) money is there as long as it serves the real output sector. In other words, the quantity of paper money in circulation should always be dictated by the demand for it coming from the real output sector. Among other things, the economic activity at a given time requires money for transaction purposes; hence having more of a facilitator role. Nevertheless, when the amount of currency in circulation is beyond the amount required by the economic activity, the amount in excess would add to the money that is going to the market to buy goods and services without adding anything to the supply side. This would result in a classical case of money supply induced inflationary pressure.

If not among the supply side factors, inflationary expectation is also another cause cited by Ethiopian authorities over the years. This explanation as well began to surface in most recent periods; but rightly so. Once an economy went through a bad inflationary time, apart from the damages to consumers' purchasing power, perhaps what experts say is the most damaging condition is the formation of inflationary expectations by the consumers. This happens when consumers, on the backdrop of persistent inflation rate, decide that high inflation would continue to be the rule of the day and hedge against future high prices by acquiring more products today. This in fact is a common phenomenon where consumers go to the market today to buy as much as possible expecting high prices in the future. Nevertheless, excess demand created by such consumers today would in effect perpetuate the pressure on the market and on the prices of commodities.

## What worked

Given the detailed position of the authorities on the possible sources for consumer price inflation in Ethiopia, one can easily imagine what the policy response would be. Yes, most recent policy response of the government for the problem had been mainly addressing the supply side issues. To a limited extent, the response has also focused on breaking bad consumer expectation about the future of inflation in the economy.

Broadly speaking, tight monetary and fiscal policy stances coupled with supply of some of the basic consumables to buyers were the core of the disinflation policy. From the get go, sharp critics of the government's macroeconomic management, the likes of the International Monetary Fund (IMF), were unhappy about its overstretched expenditure plans. In fact, it was not only the question of high and persistent inflation that bothered such critics but the possibility of such massive government expenditure to end up crowding out the private sector was another point of discomfort. Anyways, fiscal side policies as well are known to have bigger roles to play in bring inflation down to a desired level. Simply put, inflation is nothing but excess purchasing power chasing fewer goods in the market place. On the other hand, as the government expands its investment portfolio, large amount of cash will enter the economy in the form of investment spending. Hence in the short run, government spending will reach the hands of the consumers in the form of employment benefit or payment for other transactions. Given the nature of output production and supply in a market like Ethiopia's, which grows much slower than its demand counterpart, the additional spending of the government could be a cause for short term inflationary phenomenon. Adding the very nature of government expenditure in Ethiopia, which is primarily focused on infrastructure and other huge investment ventures with long term return to this equation would further reinforce the suspicions of the government spending fueling inflation in Ethiopia. As it stands at the moment, Ethiopia is among the leading countries in the continent in terms of allocating large capital budget and huge chunk of this to pro-poor investment expenditures. As far as the authorities are concerned, most of the spending on the government menu are investments that the country can not go without; but a relatively well disciplined and managed expenditure might reduce the potential pressure on the price of consumer commodities, they admit. To this effect, the government can be said to have taken a great leap during the past two years.

First and for most, while Meles was still in office, the government has passed the decision to keep the level of its budget deficit well below the 3-percent-of-the-GDP ceiling. This decision also enabled the treasury to manage its expenditure on its own throughout the year. It also completely discontinued direct withdrawal from the central bank, which is termed as printing money by the industry professionals. According to experts, direct withdrawal is the worst form of deficit financing there is, since it is said to have almost a one-to-one relationship to the rate of inflation.

It does not stop there. In fact the government has shown its seriousness regarding its target of single-digit inflation by exercising fiscal discipline over the past year or so. This included turning away additional, supplement budget requests from its various ministries and agencies. As a matter of fact, the seriousness of the commitment it has made is reflected on its adoption of new budget planning format. It is called program budgeting, and it allots money based on specific programs instead of pouring funds to agencies and ministries letting them spend as they see fit.

On the monetary side as well, the central bank, a body entrusted with the power to control monetary policy in the country, has made some firm commitments and is sticking to them. Among other things, the bank has implemented a firmly tight monetary stance since last year. Up on the recommendation of the IMF, the bank adopted quantitative anchor to gauge the growth of broad money supply. The system is said to be useful to keep the money supply in very short leash and eliminate the potential pressure it might exert on consumer prices in the market.

Apart from that, the bank also used its various monetary policy instruments to check money supply growth: commercial bank reserve requirements and interest rate adjustments are the major ones. Commercial bank reserve requirements are frequently used monetary instruments in Ethiopia, and it could increase or decrease the requirement levels depending on what it is planning to achieve. As an integral part of the country's financial system, the level of financial leverage that banks do have at their disposal has direct effect on inflation. For instance, if the reserve requirements are relatively more relaxed, it means that commercial banks do have ample financial resources at their disposal and that they can disburse large amount of loans to their customers; increasing the amount of money in the system.

On the other hand, exchange rate is also another monetary policy instrument which is controlled by the central banks of Ethiopia. In this regard as well, the bank has taken some strong measures to keep spillover effect of the exchange rate dynamics from affecting local price levels. In reference to the situation briefly mentioned above, where the country's trade balance improvement had led to high foreign exchange reserve and money supply, central bank's quick measure to sterilize the domestic market from this effect is among the list of policies which are bringing disinflation at this time. The late PM Meles, while explaining the scenario to the parliament, said that due to the sudden favorable conditions, the unexpected build up of the foreign exchange reserve of the country also had a down side from the vantage point of controlling inflation. He said, as the reserve starts accumulating, an equivalent amount of local currency will also be entering the circulation putting high pressure on prices. This, he explained, should be treated immediately by sterilizing the effect.

Another area of government's policy engagement with inflation was the supply of basic goods and commodities in the country. This measure in fact is deeply rooted in the authorities' view that some of the biggest wholesale traders in the country are abusing the market. Meles, while talking to members of the business community on the verge of imposing the price cap on 2011, set out three other options should the cap fail. One of the options was to have government institutions import some of the basic consumables and distribute them to the market. This was the second option, and the first one was to organize few local importers to bring competition back to the market. Accordingly, wheat is still being supplied to the public through local kebele offices.

**Bottom line**

Save its economically inefficient nature, government supplying basic commodities to consumers has some marked advantages to the market. First and for most, the move would break the perception of some of the most unethical wholesalers and retailers regarding the possibility of creating artificial commodity shortage by hoarding and exploiting consumers through higher prices. Secondly, and perhaps most importantly, it would break expectation of consumers with respect to these products. This is important because the consumer would not rush to market to buy beyond what they require for their immediate consumption; it would dismantle expectation of shortage in the future.

Looking at the bigger picture, however, with food items still dominating households' budget, the sense of assurance that can be created by the supply of these food items would also stand a good chance to be interpreted as an overall confidence in the macroeconomic environment of the country; inflation to be exact.

In conclusion, pundits believe that the timing could not have gotten any better for the country to get a grip on its macroeconomic problem. They argue that with the international market calmer, and price of some of Ethiopian imports stable, this is a good time to bring inflation down to its target. Finally, the long awaited inflation target appears to be just around the corner and if policymakers can hold their breath, the target looks to be achievable in month's time. No doubt this achievement would build the policy credibility of the authorities.