

The dilemma of exchange rate devaluation arrangements as solution for inclusion

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Exchange rate Volatility is a measure of risk, whether in asset pricing, portfolio optimisation, option pricing, or risk management, and presents a careful example of risk measurement, which could be the input to a variety of economic decisions. What was surprising and interesting about Ethiopia's move is that the devaluation was not undertaken under the usual duress of “macroeconomic adjustment.” Devaluation helps because it increases exports and reduces imports, thereby increasing the foreign exchange position; and it also reduces domestic spending and brings it more in line with a country's production. In this instance, however, the devaluation seems to target structural change, to boost the tradable sector so that it can provide the basis for long run growth.

Volatility of exchange rates describes uncertainty in international transactions both in goods and in financial assets. Exchange rates are modeled as forward-looking relative asset prices that reflect unanticipated change in relative demand and supply of domestic and foreign currencies, so exchange rate volatility reflects agents' expectations of changes in determinants of money supplies, interest rates and incomes. I see it differently. Tradable sectors and exports can indeed be key for development. And Africa's tradable sectors are handicapped by aid and natural resource revenues, which tend to promote non-tradable sectors and encourage consumption over production

As Ethiopia considering implementing changes in their development strategies, now is an opportune time to investigate the issue of weather alteration, in exchange rate arrangement have an effect on economic growth or to what extent exchange rate volatility may be responsible for variation in the rate of economic production. Because such moves are accompanied by increase in the volatility of both, nominal and real exchange rates. So, three slightly different takes on this Ethiopian move would be the following. First, this devaluation can be seen—not as actively favoring or even subsidizing some sectors as it would be in the case of China, for example—but as offsetting a previous distortion (aid and resource revenues). Second, instead of viewing this as creating investor uncertainty, it can perhaps be seen as a credible and durable pre-commitment to promoting structural change (provided of course future actions are consistent with this move). The private sector can be assured that there would be durable advantage in investing in the tradable sector. Finally, the devaluation is heartening if it reflects a realization on the part of African policy-makers that the key to development is structural change but one that is brought about in a market-friendly manner rather than in the dirigiste manner of the past.

Real exchange rate uncertainty can have negative effects on both domestic and foreign investment decisions. It causes reallocation of resources among the sectors and countries, between exports and imports and creates an uncertain environment for investment.

The most important reasons for a devaluation to trigger an aggregate demand contraction include: a redistribution of income towards those with high marginal propensity to save, a fall in investment, an increased debt burden, reduction in real wealth, a low government marginal propensity to spend out of tax revenue, real income declines under an initial trade deficit, increased interest rates, and increased foreign profits. On the other hand, aggregate supply may suffer after devaluation because of more expensive imported production inputs, wage indexation programmes, costlier working capital.

Frequent devaluation stimulates speculation, leading to confidence erosion. Such practice of continuous devaluation not only results in distortions in income, consumption, industrial growth and public finance, but also disturbs the harmonious blend of internal and external balance, affecting both monetary and fiscal indicators, e.g. exports, imports, manufacturing growth, money supply and so on.

Demand for exports depends on economic conditions in foreign countries, prices (relative inflation and exchange rate), and perception of quality, reliability, and so on. According to the orthodox approach, the devaluation enhances competitiveness, increases exports and bends demand toward domestically produced goods, thus expanding the production of tradables. For demand and supply side contractionary effects "Imports" measuring purchases from abroad, add to well being but may displace domestic production and drain financial resources. Changes in imports prices reflect changes in foreign prices, exchange rates and quantity.

The lack of zeal of domestic corporate executives to engage investment in the industrial sector exposes finance capital to the hazard of foreign invasion, which implies that foreign investors could take this advantage to expropriate the wealth of the nation, and thus hamper the strength of the Ethiopian economy because capital is mobile, and globalization is about interconnectedness and interdependence as the finance capital available in the economy is being moved at will to the economy of other states. Thus, globalization has brought about the domination of the Ethiopian economy since its basic export is woven around raw materials (the basis for production and further production), whereas export in Ethiopia promotes economic diversification abroad and restricts diversification in the domestic setting, placing the Ethiopian economy in an uncompetitive space in the global trade circle. Currency devaluation on the basis of a certain economic policy is something every nation does occasionally, more so amongst the developed nations than developing ones with the exception of China. Some 20 years ago Canada did it to stimulate the economy to pull it out of the early 1990s severe recession. Canada devalued the currency by 45% at some point. Then again, Canada is economically integrated with the US, over 80% is exported to the United States, and for that reason the devaluation was understandable. The timing also did have something to do with, a new trade regime was on its way being implemented (NAFTA) US did not mind for the border town States benefited from the exchange rate advantage of importing Canadian goods and products to present it for the voracious appetite of US consumers. Although the depreciation would take only a year and half but raising it back to the level it was prior to the recession, it would take over seven years. Because it would be very risky for the confidence of the Canadian economy to maintain that low exchange rate after the economy got its wing to fly, foreign investors cannot get a good return for their

investment if that low exchange rate was maintained, so instead of attracting few more investors the currency devaluing nation can lose many more investors. So, one has to show confidence on their economy by maintaining strength on their currency to reflect a good management and command.

Given the above example its not a bad idea for Ethiopia to devalue BIRR, however the trade deficit Ethiopia has is far greater to compensate by the export increase it will have no matter how large the export is, because Ethiopia is an 80 million nation with trade deficit is into billions. So devaluing the currency may encourage one time (short term) investors to come and take advantage but they will leave once that advantage runs its course. Those who buy real estate would benefit from the exchange rate advantage it will give them, but all others things will rise immediately after. As illustrated above, Ethiopia is an import economy nation. In the long term the country could lose its ability to maintain that same juice stimulant for an extended period of time knowing the way I know Ethiopia.

China on the other hand can manipulate its currency as much as it wants for however long it desires for it has a huge reserve, essentially driving the world currency exchange rate. Alluding to the fact, if one controls the US currency, one has the world in their pocket. Ethiopia does not have excessive reserve like China does, as a matter of fact Ethiopia is running a yearly deficit economy, which means it cannot do what China does and come out unscathed. It may help it for a one time currency collection by giving the labor of the citizens to the foreign investor accumulating the extra 20% and using that extra juice the one time foreign investor can increase the margin of profit by a 20%. However, that's where it stops. The nation would have to devalue its currency further down in order to get another stimulant juice; the question then becomes where the devaluing stop does.

The basic adjustment policy dilemma may be easily illustrated by the simplest of all open economy frameworks where: exports, imports, aggregate domestic output, consumption, investment and government expenditure.

Matters would be relatively clear cut if there were well defined correct and incorrect policies relating to macroeconomic stability, microeconomic efficiency and openness.

A bad harvest, or a fall in export prices may reduce both export revenue and tax revenue. Or, where sovereign debt is denominated in US dollars, an increase in world interest rates or an appreciation in the US dollar will lead to an increase in government expenditure expressed in domestic currency. Apart from such exogenous shocks, it may also be the case that the characteristics typically found in Ethiopia make it more of a challenge to conduct macroeconomic management. It may be more difficult to control government expenditure, to increase tax revenue, to avoid monetising fiscal deficits, to control the supply of money and to pursue inflation targeting. Exchange rate depreciation may also be less effective if the inflation it induces impedes its relative price effect, if foreign trade price elasticities are relatively low.

Similarly, the counter-inflationary effects of overvalued exchange rates are unlikely to offer sufficient compensation for the erosion of international competitiveness and the expectations of devaluation to which they lead. Policy prescriptions relating to structural adjustment and the supply side. There is less consensus surrounding the causes of economic growth and the effects of openness, with the consequence that there is more debate and disagreement about what policies will increase aggregate supply in the long run. What is the appropriate role of the state? To what extent will privatization stimulate

growth? Which elements of government expenditure show the biggest return in terms of economic growth? What is the impact of openness and trade liberalization on growth? What is the connection between financial liberalization and growth? In what order should Ethiopia exhibit a relatively high degree of export concentration on commodities whose price in world markets is often unstable. At the same time, where the price is denominated in US dollars, variations in the price of the dollar may be another factor in determining how the international purchasing power of a specific volume of exports may change.

So where does this leave us? If it seems to imply that the issues are highly complex, that our understanding of them is still limited, that there is a potentially explosive combination of economics and politics, and that there are no easy answers, then it is because this is exactly what the situation is. But at the same time the absence of easy answers is not an argument for policy inaction. It is a matter of learning by doing, trying to avoid doing harm, and gradually evolving towards a better outcome. The technical (and political) question to be raised is the following: is it really possible – in order to raise and maintain economic growth at 11-15% per year for a longer time - to have a much better exchange rate for the current account balance and, at the same time, a lower nominal interest rate, without igniting inflationary pressures in the Ethiopian economy?

The answer – as always in macroeconomics – is maybe yes. It all depends on inflation expectations, exchange rate expectations, monetary and fiscal policy. Any simple macromodel normally suggests that, in an open economy, inflation is determined by expectations of inflation, the output gap and the rate of exchange devaluation. Additionally, it is well known that the interest rate differential with respect to the rest of the world tends to reflect the expected rate of exchange devaluation. Furthermore, economic growth depends on the existing output gap, as well as monetary and fiscal policy (in addition to long-term trends, of course, such as productivity and demographics). Even a simple model like this shows that the major challenge is to promote a devaluation of the currency (under fixed-but-adjustable rates or under dirty-floating rates) which might be able to bring the expected rate of future exchange devaluations to zero or even “negative” figures. And, at the same time, it must represent a real devaluation, with a small impact on domestic inflation. Is that possible? Again: maybe yes.