**Birr Devaluation – Will it correct Ethiopia's trade deficit problem?**

[appeared as Economic Commentary in AddisFortune Vol, 11, No. 541, 12 September 2010]

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The surprise devaluation of the birr on August 31, 2010 from a value of 13.63 to the US dollar to 16.35 was apparently undertaken to boost export performance and bring about structural change in the economy. This was a bold and important move because it indicates recognition by the Ethiopian government that its policy setting had been a factor in inhibiting Ethiopia's external performance and industrial development. However, by itself, this move might fall short of addressing the trade problem, which is manifest in a low trade share of GDP and a yawning trade deficit and which reflects numerous and complex factors, while raising other questions regarding the government's approach to macroeconomic stability that now need to be answered.

The first question is how strongly will trade flows respond to the devaluation? While persistent over-valuation of the currency was an important contributing factor to the widening of Ethiopia's trade deficit, it was only one of many factors hampering Ethiopia's exports. Accordingly, devaluation *alone* might prove to be disappointing, at least in the short term.

There are two concerns in this regard, which would appear to be salient in view of the perceived need for a further devaluation at this time, hot on the heels of a sequence of previous devaluations over the past two years.

First, the trade balance will correct only if the response of import and export demand to the price changes induced by the devaluation is sufficiently strong—technically, the sum of the import and export demand elasticities must be greater than one. In the context of a developing country which is importing goods that in many cases have no domestically produced substitutes, and is exporting commodities for which demand tends to be unresponsive to price changes, the sum of the trade elasticities may indeed by less than unity, at least in the short run.

Further, market structure may work to dampen the impact of the devaluation. Commodities produced by developing countries are often sold into commodity markets dominated by a few major international buyers whose market power enables them to appropriate the rents; because of this market structure, it is quite possible for the devaluation to boost the profits of international buyers with little of the benefit trickling down to the Ethiopian producers in the form of higher profit margins on export sales. By the same token, this would limit the supply response and thus the extent of correction in the external balance. At the same time, given high margins in the Ethiopian distribution system, import price increases due to the devaluation may not be fully passed onto final buyers, if importing wholesalers choose to absorb some of the increased import price to maintain higher volumes of sales; this could also work to reduce the speed of correction in the trade balance.

Accordingly, a more comprehensive policy package with complementary initiatives to enhance the supply response to the devaluation, sustained over the medium term, is required to redress an external deficit generated by years of policy settings inimical to good export performance and industrial development. This package would include policy reforms to reduce the administrative burdens on exports and imports to cut the time and other costs of trade, infrastructure development on the main trade corridor to sharply lower the cost of getting goods to international markets, implementation of risk-based customs inspection procedures and entry into international transit agreements to minimize delays and costs due to repeated unstuffing of containers for inspection, and perhaps most importantly policy reforms to reduce the difficulty of establishing productive enterprises to speed up the development of the private sector, which after all carries the burden of generating the export supply response that must be there if the trade deficit is to be closed.

Some of the transportation infrastructure projects proposed in the new Growth and Transformation Plan (GTP) are steps in the right directions. However, questions can be raised about the intended sequencing of road development before the railway construction is to be even tendered, given that rail is more cost-efficient for long-haul goods transport. In particular, if the planned rail projects (especially the Addis Ababa-Dire Dawa-Dewele links) were to guarantee a high-speed, heavy-duty, high-capacity rail link to global markets, this would be the transformational, game-changing development that Ethiopian exporters need.

What has been so grievously missing in the past and is greatly needed now given the concerns identified above is a structured engagement with the private sector to identify and address binding constraints in the business environment. The GTP is to be presented to the public for discussion and feedback on a regional and federal level is to be solicited, perhaps a first-ever development in Ethiopia. Let us hope that it will be presented as a living document, open to genuine evolution based on the input, not just to address squeaky wheels. Policy makers need to be attuned to the private sector's pulse, most especially on the matter of competitiveness.

The second question is raised by the role that the exchange rate peg has played in promoting domestic price stability. The apparent shift in exchange rate policy to boost export performance and foster domestic structural transformation leaves open the question of what strategy the government will now follow to maintain macroeconomic stability.

Various instruments are available to central banks to conduct policy as they seek to promote price stability and economic growth. In Ethiopia's case, where price stability, growth and export competitiveness are all concerns, it is useful to consider the issue in terms of the monetary conditions index. This index expresses a given degree of monetary restraint as a weighted average of movements in interest rates and in exchange rates, according to their respective estimated effects on aggregate demand. A given degree of monetary restraint chosen to reflect macroeconomic conditions (e.g., restraining inflation or supporting growth) can be achieved with alternative combinations of higher (lower) real interest rates and lower (higher) valuations of the exchange rate.

By establishing the monetary conditions index as part of the basic frame of reference for Ethiopia's monetary policy, the implications for price stability and growth of policy moves such as the recent birr devaluation could be evaluated. This would provide guidance regarding the possible need for complementary adjustments to interest rate policy and/or fiscal policy and, by the same token, would help answer questions that the investor community might have concerning the implications for inflation.

Further, given the international ramifications of using exchange rate policies to address competitiveness issues, it would be highly useful for Ethiopia to establish a benchmark for what might be in some sense a “fair” valuation of the birr. There is no straightforward answer to the question of how to arrive at such a valuation. Given the huge global imbalances and the very wide swings of the real exchange rates of the major currencies against each other, the global exchange rate setting is far from anything that might be considered representative of “equilibrium”; by the same token, it is problematic to speak of equilibrium exchange rates for a non-traded minor currency such as the birr. History is a poor guide as to what would be an appropriate birr value since large aid flows allowed higher valuations than would otherwise have been possible, creating a “Dutch disease” effect for the industrial sector. Wide historical swings in the prices of major import and export commodities such as oil and coffee and large growth differentials compared to trading partners during the growth spurt enjoyed by Ethiopia in the last half decade further complicate the analysis of exchange rate valuations based on macroeconomic “fundamentals”. Purchasing power parity exchange rates such as those calculated by the World Bank also provide no guidance in Ethiopia’s case because of the huge part of the economy that is not functioning at market prices.

One approach which could be used as an interim measure and which has the benefit of simplicity is to use the trade balance in goods excluding the major import and export commodities (oil and coffee) and capital goods (imports of which would be reasonably expected to generate a trade deficit in a country growing as rapidly as Ethiopia) as an indicator of whether trade deficits are benign or reflective of excessive consumption and an anti-export bias in the policy setting.

Armed with these benchmarks and monitoring the trade responses to the recent exchange rate changes, Ethiopia would be in a position to choose an appropriate policy mix to advance its growth and price stability objectives while also maintaining competitive conditions for its exporter community—and to provide analytical support for its policies in its public statements