

# **Response to Dr. Said Hassan: On the cause of the current Ethiopia soaring inflation rate**

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## **Part II**

It is my belief that the writer got the clear message from my part I response about his wrong assessment of our PM. In my part II response I will use suitable and available data to nullify his four explanations about the cause of inflation in Ethiopia. I focused only on these four because of the following reasons. My first reason is there are many repetitions in identifying the cause of inflation in Ethiopia by the writer. For instance: he says, “Increase in money supply, increase in money supply from abroad and remittance”. The end result of all these variables is to increase local money supply (broad money) which is believed to be the cause for increasing demand for goods and services. As I pointed out before, the intention of the writer is to increase the number of reasons to blame the government. The second reason is the writer uses his perception (non factual data) than using the real measured and factual data to explain the cause of inflation. Such kind of identifying cause of inflation based on personal perception without measured data/fact does not deserve my reply.

I am the kind of person who relies on the various measured data in the country rather than personal perception like Dr. Said Hassan. Just to substantiate my argument the writer mentioned war expenditure as a reason for inflation in Ethiopia. But our big professor from USA could not provide any factual data or theoretical links which show the increase of inflation due to war expenditure. If we are talking about particular time and country, we should have the ability to show our idea by using the real data. Rather than explaining how the war expenditure increases the inflation, the writer wants to tell us about May 2005 election and the “unpopularity” of our government. There are many ill conceived distortions like this in his analysis, which have no relation whatsoever to the reality on the ground. It is a matter of vision we have for our country. The third reason is I partially accept some of the causes for inflation which as identified by the writer. I do agree that soaring oil price, increasing world food price and monetization of aid are causes of inflation but my final conclusion differs very much from that of the writer. The last reason but not least is the writer’s idea is contradictory throughout his explanation. For instance he says “increase in money from abroad and remittance” is the cause for inflation. In one part of his analysis he wants to tell us the declining foreign reserve would lead to financial crisis. My question is how could two extremely different situations “increase money supply from abroad and decline foreign reserve” occur in one country at the same time?

Based on the above observations I decided to look into detail to the four major reasons as identified by the writer “**Increase in money supply, increase in money supply from abroad, shortages-both food and finished product, budget and current account deficit**”. In addition of defining the concepts of each variable I will use the possible data to show the real picture in the country. Then accordingly I will leave the judgment to my readers about the writer’s analysis. The other point the writer failed to mention was the poor functioning of local market and institutional barrier which happen to be the main contributors of inflation. Any way let me leave these for the writer to reflect on and proceed to my main point.

**1. Increase in money supply.** The writer's first reason for the cause of inflation was the increase in money supply. Here he went to tell us that the Ethiopian government is printing money to finance its budget deficit. The writer's problem begins from misunderstanding the concept of money supply. From his analysis I could only deduct that his understanding of money supply was of only printing money<sup>1</sup>. I arrived at that conclusion because the writer did not mention any other component of money supply in his analysis. In the context of Ethiopia, money supply refers to the summation of Narrow Money (M1) (Currency outside banks and demand deposit<sup>2</sup>) and Quasi-Money (M2) (Saving deposit<sup>3</sup> and Time Deposit<sup>4</sup>). In other words all these components of money supply together are called broad money. I would like to remind my readers that the component of money supply varies based on the level of financial sector development in the country. The money supply of developed countries includes more components based on the level of development in their financial sector.

Therefore, the writer should know that Ethiopia has never printed money to finance its economy even during Ethio-Eritrea war. During that time the deficit was 7 million Birr which was financed by domestic and external borrowing. Even in 2006/07 the government covered 85 percent of its budget by domestic revenue which included grant. The remaining 15 percent of the budget (6.2 billion birr) was financed by net external borrowing and net domestic borrowing. In this year the net domestic borrowing covers 4.25 billion birr through the banking system and the remains 1.9 billion birr is covered by external borrowing. To be more clear for the writer and my reader the domestic source of deficit finance are the selling of Treasury bill and government bond. In 2006/07, the National Bank sold Treasury bills worth Birr 65.3 billion to mobilize the non-inflationary resources to cover Government budget deficit (MoFED, 2006/07)<sup>5</sup>.

The other analysis the writer addressed was on the relatively fast broad money increase in recent years. It is public secret about the growth of the broad money. The mistake of the writer again is he did not ask further why this happened; rather he chose to circumvent the real reason to say the economy is not developed. As you can see above, the money supply increased due to the change in components of broad money. Broad money supply grew by 22.2 percent during fiscal year 2006/07 compared with last year, reflecting an increase in the transaction demand for money<sup>6</sup> (NBE, 2006/07). To see further the broad money increase in the country arose due to the increase in both domestic credit (25.5%) and net foreign asset (10.2%). Even the increase in the domestic credit came about by the borrowing of government and private sector. To put it in terms of numbers, at the end of June 2007, the government borrowing increased by 20 percent as

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<sup>1</sup> It refers to the total amount of money held by the nonbank public at a point in time in an economy. There are several ways to measure such an amount (called a monetary aggregate), but each includes currency in circulation plus demand deposits (checking-account money)

<sup>2</sup> An account from which deposited funds can be withdrawn at any time without any notice to the depository institution

<sup>3</sup> Savings deposit is a deposit account intended for funds that are expected to stay in for the short term. A savings account offers lower returns than the market rates

<sup>4</sup> A time deposit is a money deposit at a banking institution that cannot be withdrawn for a certain "term" or period of time

<sup>5</sup> Ethiopia's monetary policy continued to focus on maintaining price and exchange rate stability so as to create conducive macroeconomic environment that promotes economic growth

<sup>6</sup> Transaction demand for money refers to the money needed to accommodate a firm's expected cash transactions

compared to 31percent growth of the private sector borrowing. When you consider the massive development activities in the country, the government borrowing growth is not significant.<sup>7</sup>

The last point which shows the worst level of the writer is when he attempts to link this growth of broad money and excess reserve with party owned parastatal<sup>8</sup>. He said:

*As far as Ethiopia is concerned, the IMF has reported that the broad money supply in Ethiopia has been growing relatively fast in recent years. The excess reserves that the entire banking system is faced with also indicate that the system is flooded with cash, among other things. **This stealth way of financing government spending and party owned parastatals is dangerous and is an outright theft of the public.***

As seen in the above quoted paragraph, on one hand he used IMF reports which indicate there is excess reserve in the bank. On the other hand he wants to tell us that the government is spending public money to party owned parastatal. For any one who has read the writer's analysis it is easy to see his contradictory remarks regarding excess reserve in the bank and spending public money for party owned parastatal. If the government had taken the money and used it to its own affiliated party, then IMF would have not reported there is excess reserve in the bank. The excess reserve occurred due to more savings by the people and the high condition available for financial institutions to provide loan to any borrower.

Here what I want to emphasize is that there is an increase in broad money (money supply) as explained earlier. In 2006/07 the aggregate total expenditure reached to 183 billion birr mainly due to this. However, in the same year the Gross National Product was only 171 billion birr. The extra 10 billion birr paid was surely the major cause for inflation in the economy. To many it was a surprise that the aggregate expenditure arose more by private expenditure than by government expenditure. The private expenditure which was 110 billion in 2005/06 increased to 143 billion birr in 2006/07 as compared to the government expenditure which increased from 15 billion to 18 billion birr in the same years. In this regard we cannot blame the government for providing suitable environment for the private sector to invest in the economy. Rather the blame should have been why the government did not predict this gap between aggregate demand and supply in order to set a suitable measure to increase the aggregate supply. If this were done before the government does not need to interfere to correct the market failure.

Despite its poor prediction capacity, the current government is doing its level best to shift the country's financial sector to a modern and sustainable financial institution<sup>9</sup>. It is highly unfortunate to see this kind of weak analysis at this time from the big professor. This kind of analysis does not contribute anything to the transformation process of the financial sector in Ethiopia; rather it reduces the speed of the government's effort in changing the financial sector.

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<sup>7</sup> This growth rate was lower than the 29.8 percent nominal GDP growth registered in 2006/07 showing prudent monetary policy

<sup>8</sup> A parastatal is a fully or partially state-owned corporation or government agency

<sup>9</sup> The major development that has occurred in recent year in the financial sector in Ethiopia is the strengthening of National Bank of Ethiopia. The central bank is currently implementing a five year strategic plan. The main objective of the bank are to undertake task concerning service delivery by the bank, enhancing the soundness of the financial system, making available timely research and policy advice to the government, building an efficient payment system and enhancing currency management.

**2. Increase in money supply from abroad.** The second cause identified by the writer is the increase in money supply from abroad as another cause of inflation in Ethiopia. But as I said before the writer wants to play with economic variables only from book knowledge to undermine the Ethiopian Economy. In a country where export is only around 30 .percent of import or 12 percent Gross National Product, the increased money from abroad plays a significant role; it increases the foreign reserve in the country. It also enables the country to import new technology and heavy machineries (Industrial equipments) that will be used to transform the economy. In addition to this, it enables the county to have a relatively stable exchange rate. Understanding this, the Ethiopian Government has been working day and night attracting more external loan/aid. It has also managed to secure foreign aid/loan to Ethiopia, despite the fight of the anti-Ethiopian elements to paralyze Ethiopia's course of development.

Before going into generalizing like the writer did, we have to ask the question. For what purpose is foreign aid being used in Ethiopia? Are we using the money to pay salary or to buy machine or equipment? Are we using the money to buy goods and services or to develop new programs to change institutional problems we have that deter the growth of our economy? The incumbent current government clearly stated in its policy document; that the external resource that comes from abroad should be allocated for capital expenditure which is unlikely to increase the demand for goods and services. The current rural electrification, telecommunication expansion, infrastructure provision and other development work is the outcome of the proper utilization of external loan for intended purposes. Here the writer himself knows that the internal revenue mobilization capacity of Ethiopia cannot bring the current change we are looking today.

Without knowing what is going on in the country the writer said in his analysis that the **huge volume of money entering the country bolsters the demand for goods and services a result increase and the risk of inflation and suggests** unless their impact is thwarted by raising interest rate on the treasury bills to ease inflationary pressure. If the writers argument could be true for Ethiopia I would have accepted his argument, but his statement is just a copy of text book relationship between foreign aid and inflation which does not reflect Ethiopia's reality. In Ethiopia the government is using the foreign aid for capital expenditure and new program development which is expected to increase production and remove various institutional constraints in the economy. This is the first mistake of the writer. The second mistake of the writer is he proposes the increase of interest rate which is currently criticized by Joseph E. Stiglitz, professor of Economics at Columbia University.<sup>10</sup> Professor Joseph E. Stigilitz explains how the writer is wrong to say low interest rate is the cause for inflation. But here to remind my readers I would do not like to say there is no new demand for goods and services due to new employment opportunity created by the government development program. But my argument is, that it is insignificant because the government has already taken steps to deter external fund from creating inflationary pressure.

**3. Budget and current account deficit:** The writer also mentions the budget and current account deficit as the other cause of inflation although he failed to say any thing about the current account deficit. The writer begins his explanation by defining only budget deficit<sup>11</sup>. After his

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<sup>10</sup> Addis Fortune private news paper march 11, 2008, commentary page

<sup>11</sup> I am not clear why the writer mention current account deficit but could not say any things about it

proper definition of budget deficit the writer runs to his usual business by computing the 54 percent debt/GDP to map up his pessimistic analysis<sup>12</sup>. The writer speculates and hypothesizes if the debt/GDP is above 100 percent. Here my critic for the writer is not about the level of expectation rather his estimation is not based on the past and present experience of debt to GDP ratio in the country. Rather than predicting the future with concrete and justifiable reason, the writer makes his personal and unrealistic estimation about future debt/GDP. In 2001/02, the external debt/GDP was 83.7 percent and declined to 40 percent in 2006/07. The reason for the decline in debt/GDP ratio is due to the higher growth of GDP rather than the growth of debt during the last few years. The past trend and the future development direction of the government would not permit for debt/GDP to be 100.

The other thing the writer failed to analyse in terms of domestic and external debt. Why I am bringing this is because both types of debt do not have the same level of contribution in creating inflation. If the domestic debt/GDP is high, it might aggravate inflation in the country unlike the external debt/GDP. But the same year data that shows the domestic debt/GDP in Ethiopia is 17.6 percent. The highest debt/GDP mentioned by the writer is due to the external loan received by the government from international organizations. Here I will ask my readers: shall we advise the government to cut external loan at the expense of poor people who need education and health service for reducing debt/GDP? Shall we cut external loan by the cost of the new program that supposes to improve the efficiency of the economy?

It is not logical to cut our development to see just the lower figure of debt/GDP, rather the solution is to receive the external loan and use it for capital expenditure which enables us to pay back the loan we received from external sources. If this is the case we will achieve economic development and at the same time we will pay the loan from the return we get from capital investment. This is the area that the writer lacks understanding on the implication of debt/GDP. In addition to this problem he proposes a silly solution to reduce budget deficit: cutting government spending and/or increasing tax. What irritates me here is that he knows his solution leads to an economic recession. Firstly his proposal is too narrow, because there are many other alternatives that can increase local revenue to reduce debt/GDP: 1) spending government expenditure on more productive area as solution which enables the government to pay the loan; 2) The government can broaden tax base rather than increasing tax rate; 3. The government can also improve tax administration's capacity to increase tax revenue. 4) Government can modernize its tax assessment and collection system to control tax evasion. Secondly is there any government who proposes solution to create other economic problems (economic recession)?

Anyway to come to our main point, higher debt to GDP ratio indicates there is new money that enters to the economy. The question should be where this money is spent in the economy. It should be asked if the money is used for non-inflationary activity: Increasing the production and the productivity of the economy, higher debt/GDP cannot be the main reason for inflation. In contrast to this if the new money spent to increase the demand for goods and services will increase inflation and create debt crisis. But when I observe the reality in the ground the latter

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<sup>12</sup> *THE ETHIOPIAN ECONOMY CONTINUES the strong performance witnessed since 2004, with real GDP estimated to have grown by 8.2 per cent in 2006/07. This growth was broad-based, with industry, agriculture and services all expanding strongly (OECD, 2008,P. 303).*

case is highly unlikely in Ethiopia. In 1995/96 the percentage share of capital expenditure was 34 percent (3 billion birr) of total expenditure, but the recent data in 2006/07 revealed that the capital expenditure share increased to 51 percent (18 billion birr) of the total expenditure. Even in 2007/08 out of the total expenditure about 47.4% is recurrent and 52.6 % capital expenditure. This is a clear indication that more government resource is allocated to capital expenditure which speeds up economic development. I hope the writer knows how this will enable the country to pay the current high debt in the future. Here I do not blame the writer because he does not know the practical tragedy behind the figure in Ethiopia<sup>13</sup>.

**4. Shortage –both food and finished product;** The last part which I want to nullify the explanation of the writer is the shortage –both food and finished goods. Let me begin by putting what the writer said. *The real and major culprit behind the rampant inflation rate is, in fact, the existing shortage as evidence by the fast rising food and finished product price.* The writer seems to not know any other factor other than shortage of product for the increase of price. It is hard to say the price increase is mainly due the shortage of the food and finished goods in Ethiopia. Most of the time price increases when the cost of production changes. Even if we have surplus product (no shortage) we can see an increase in the price of goods. The changes in price usually arise due to the change in the cost incurred for production and distribution of the food and finished products. That is why in the Ethiopian context the product is available but the price of the product increase is due to the increase of the cost of production and other factors. The writer himself said the cause of rampant inflation is the increase in world food price, increase of oil price, increase in money supply, the monetization of food aid and budget deficit. Against of his earlier arguments in this part he tries to tell us that the real cause of inflation is the shortage of both food and finished goods.

In Ethiopia the cost of production/distribution increased on one side and at the same time the demand for goods and finished products increased due to the increase in aggregate expenditure in the economy. These changes are not supported by efficient and transparent market in the country. Then all these situations that happen in the country at the same time increase the price more than our expectation. No one is saying that there is no product in the market; rather it is fair to conclude that the price is high for the product that is available everywhere in the market. Let me give you a suitable example. The National Bank report indicates that the cereal production in 2006/07 was 116,243 showing an increase up to 136.583 in 2006/07. That means the cereal production has increased by 17.7 percent as compared to 2005/06. Here due to various factors (increase of fuel oil price, increase price of fertilizer and inefficient market structure) we saw the cost of cereal production increase which increased the price of cereal in the market by 15 percent in the same year. You see the writer's analysis is the bare minimum of Economics 101 as he has demonstrated in his non-technical paper.

I hope the four points which I have mentioned above clearly indicates the writer's poor analysis about the cause of inflation. He has presented a wrong analysis which does not reflect the reality on the ground. In summary, I would like to tell my readers that inflation is not an uncommon phenomenon in the recovering economy like Ethiopia. It is to be expected especially in a country

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<sup>13</sup> It is worth noting that the share of capital expenditure stood at 40%, 46% , 48% and 52% during fiscal years 2003/04 ,2004/05, 2005/06 and 2006/07, respectively.

where no strong and efficient market structure, poor prediction capability about the future<sup>14</sup>, poor coordination of economic policy preparation and implementation and weak institutional set up exists. The current government is working for economic growth (development) on one side and restructuring the economy on the other side. If we want to break the vicious circle of poverty<sup>15</sup> in Ethiopia the only option is to work hard in all directions of the economy like the way the government is doing now. At this time it is obvious to see the ups and downs of some economic variables in the economy. This is an undeniable fact where the country problem is beyond its capacity (financial and physical capacity). We all should accept that there is a cost for improvement, but the question should be how to minimize the cost of this improvement.

I heard in the parliament when the opposition asked the government to cut the expenditure in construction and other development activity and allocate it for salary and subsidy. The people who think like this do not know where the money is coming from. It is unfair to survive at the cost of the future generation. I appreciate this government because it is allocating its budget in the productive areas and dismissing the unproductive areas. What is the return for the economy if we pay all government budgets for salary and subsidy? The Western countries reached development today because of their selective and purposeful allocation of budget in social and institutional development. But this could not have happened in our country during the previous regimes. Today the government's direction and resource allocation needs support and encouragement since it is working to end our poverty and create a new image of Ethiopia in the world. In this regard our only option is to embrace each other and implement the suitable economic policy based on other countries experiences. Before criticizing the government we have to watch and closely follow the development of the country and evaluate it with the potential problem we have in the country. I am sure this enables us to know where the failure of the government is and at the same time it enables us to propose the right and possible solution for our people. Without logic if we list down critics without knowing the reality on the ground then it will only be echoing text book theory which will not go beyond paper work. Today, we should stand for Ethiopia and our discussions should revolve around the Ethiopian context and not recite Economics 101.

## **GOD BLEASE ETHIOPIA!!!!**

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<sup>14</sup> The first annual report of PASDEP revealed that the objective of the Bank to contain core inflation below 10 % was not realized as it reached 15.2% during 2006/07. The pass-through of foreign inflation (particularly that of fuel oil and construction materials) on domestic prices, the substantial jump in the prices of construction materials due to intense demand in the sector and the upward revision of water and electricity charges and tariffs could be the major factors behind the observed surge in core inflation.

<sup>15</sup> Spending on poverty-oriented sectors as a ratio to total public spending increased by nearly 3 percentage points, from about 60% in 2005/06 to nearly 63% in 2006/07