A Response to Tsehai Alemayehu on Devaluing The Birr
August 13, 2014
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First if all, I thank Professor Alemayehu for both reading my commentary and for pointing out a technical error that I made while trying to show the appreciation of the birr's real exchange rate. Professor Alemayehu's commentary and positive criticism was brought to my attention about a week ago by Professor Messay Kebede. I debated on whether to send a thank you note to Professor Alemayehu, respond to him by disseminating my response or do nothing. The decision up this point was to do nothing since, as Professor Alemayehu correctly articulated, there is no difference in substance between the two of us regarding the likely consequences of the devaluation of the Ethiopian birr. I am disseminating this response in light of the fact that Professor Alemayehu has now posted a second commentary, which itself is a response to Professor Teshome Abebe's commentary. For obvious reason, his response (my) has nothing to do with Professor Abebe's commentary.

The Technical Error: While trying to show the appreciation of the real exchange rate, I used a simple and standard formula for currency appreciation (a formula used to calculate changes in percentage prices, such as inflation) instead of depreciation. In short, Professor Alemayehu's calculation of 17.3%, regarding what I referred to as "stealth devaluation" is technically the "correct one" – per the suggested formula, instead of the 21% that I suggested. I strongly argue, however, that the reality is closer to, if not higher than, to the 21% since both my and professor Alemayehu's calculations are static in nature and exclude compounding and the impact of expectations.

Reasons for using the formula: In my article that was disseminated on August 1, 2014, I reluctantly used the standard and simplest formula which depicts the relationship between the nominal and real exchange rates. I reluctantly used that formula partly because I happen to receive messages and complaints (beginning all the way back to 2008), largely from laypersons, who either disagree with my assertions of the overvaluation of the birr and/or do not understand how it works. As I stated in the same article, some bloggers and commentators also happen to continuously make similar mistakes. I used that simple formula hoping that presenting it would serve as a good learning moment for them and to show some others that there are some theoretical and technicalities involved behind the assertion of the appreciation of the birr's real exchange rate.

Remittances and Foreign Aid Flows and Real Exchange Rate Appreciation: I am somewhat mystified by Professor Alemayehu's suggestion that I have made an error on this issue. In the same article, I stated that the huge remittance and foreign aid flows contribute (and, not cause) the appreciation of the birr's exchange rate (overvaluation of the birr.) On domestic grounds, the birr's value has been falling due to rising costs of living and inflation rates. But, both the official and the suppressed and interfered with black market exchange rates fail to reflect this fact, thereby raising the real exchange rate. In case Professor Alemayehu or anyone else is not aware, the international economics literature is replete of remittance and foreign aid flows causing and contributing to real exchange rate appreciations and even leading to what is known as the Dutch Disease. Here is the other point that I was making, albeit indirectly: Amusingly, both the World Bank and the authorities encourage foreign aid flows into the country, even though I and many notable experts, such as Professor William Easterly believe that a good portion of foreign aid has been misused and abused by both donors and recipient countries and has been counter-productive to aid recipient countries such as Ethiopia. When it comes to remittance flows, the over 160,000 Saudi repatriation of Ethiopians, their mistreatments and the mishandling of the issue by Ethiopian authorities reveal the existence of a policy of exporting of people and benefitting from their concomitant remittances- one of the current research topic of mine. But, as suggested above, these flows contribute to the overvaluation of the real exchange rate. Given the policy of using remittance and aid flows as promoters and growth instruments, one could easily observe devaluation measures being exercises in perpetuity (and exercises in futility.)