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The Rich Expand, the Poor Contract.

The Paradox of Macroeconomic Policy in Ethiopia

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Rich countries have earmarked about $7 trillion to reverse the current global economic slump. The United States allotted $700 million to rescue ailing banks. About $180 billion was used to rescue just one insurer (AIG). A $787 billion stimulus package is also in place. The United Kingdom set aside $692 billion. The Chinese announced a $586 billion fiscal stimulus. Monetary policy has also become expansionary. The US and the UK cut interest rates to zero per cent and 0.5 per cent, respectively. Can low-income countries embark on such expansionary fiscal and monetary policies? Unfortunately not, as the case of Ethiopia demonstrates.

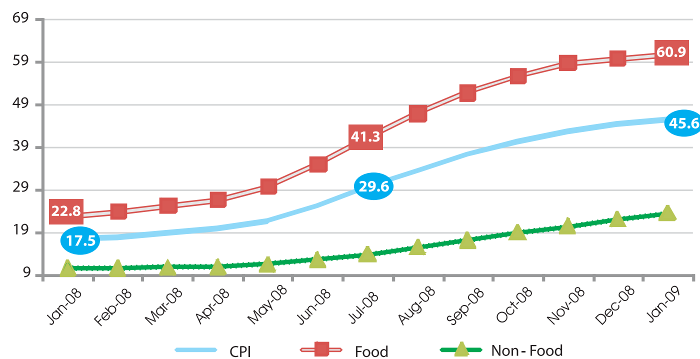
The government of Ethiopia and the International Monetary Fund (IMF) recently agreed on austere macroeconomic package. It included tight fiscal policy, with government domestic borrowing targeted at zero—down from 2.7 per cent of GDP in the previous fiscal year (2007/2008). Domestic borrowing by public enterprises is to be kept to 1.1–2.2 per cent of GDP, down from 4.4 per cent. Tight monetary policy will limit broad money growth to less than 20 per cent, down from 23 per cent growth in the previous fiscal year. The reserve requirement of commercial banks was also increased from 5 per cent to 15 per cent. The birr was depreciated by 10 per cent against the US dollar (see IMF, 2009)

Why is Ethiopia deflating while inflating is the order of the day? The answer lies with recent trends in inflation. The figure shows that the consumer price index (CPI) jumped from 17.5 per cent in January 2008 to 45.6 per cent in January 2009. In the same period, food inflation almost tripled from 22.8 per cent to 60.9 per cent. Non-food prices more than doubled to 23.4 per cent from 10.5 per cent.

Import prices have fuelled inflation. Data from the National Bank of Ethiopia indicate that food and petroleum imports, as a share of merchandise imports, account for about 21.5 per cent and 12 per cent, respectively. Between 2006 and 2008, the price of petroleum imports rose by 74.6 per cent. The entire import bill has risen by 50 per cent.

If exogenous shocks pushed up prices, then low global demand—combined with lower commodity and energy prices—is likely to drive down prices in the coming months. If so, is the austere macroeconomic stance justified? Contractions of this magnitude seem an overreaction. Public expenditure cuts often fall on investment rather than consumption. In the face of exogenous shocks, fiscal expansion is incorrectly seen as adding to demand, which leads to the prescription of austerity to a least-developed country. Macroeconomic tightening is a cruel medicine. The short-term contractions can have devastating long-term consequences, including a reduction in investments related to attainment of the Millennium Development Goals (MDGs).

Inflation Rates



Sources: The Ethiopian Central Statistical Agency (CSA) and the National Bank of Ethiopia (NBA), online databases.

What is the alternative policy stance? The Ethiopian economy, beyond external factors, is suffering from a failure to stimulate the supply side, mainly agricultural productivity. The strategy pursued in the last 18 years was successful in providing inputs and raising output levels, but it has failed to lift farmers out of the subsistence quagmire. Harvests rely heavily on rain, with only 2.5 per cent of the crop land irrigated and three tractors used per 100 sq. km of arable land. Fertiliser and machinery are costly and crop prices do not grow as much in boom years. Farmers often face unfavourable terms of trade. The extent of the market is limited by the low (14 per cent) level of urbanisation. Access to existing markets is impeded by the lack of infrastructure and market institutions (see Anderson et al., 2007).

Credit expansion, to both the public and private sector, can be directed to investments in urban developments, irrigation, rural infrastructure, agricultural research and market developments. The establishment of the Ethiopian Commodities Exchange (ECX) in 2008 is one step forward. The ECX aims to efficiently link buyers and sellers of farm produce through secure payment systems, grading of produce and the provision of reliable information on prices. Such institutional innovations and investments cannot be realised by the tightening of fiscal and monetary policies.

Whereas trillions are earmarked for the various stimulus packages and bank bailouts in the rich countries, the poor are condemned to settle for a new brand of the Washington Consensus.

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