

# Sources of Inflation and Economic Growth in Ethiopia: Descriptive Analysis

## Part I

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### 1. Introduction

Currently the objective of any developing country is to achieve sustainable economic development. Economic development refers to multidimensional process of reorientation and reorganization of the entire economic system in the country. To realize economic development the country must achieve continuous economic growth at least for two decades. China and other East-Asian countries have recorded three decades of economic growth to reach economic development. One of the pre-conditions for economic growth is a stable macroeconomic<sup>2</sup> environment. Large fluctuations in output, employment and inflation add uncertainty for firms, consumers and the public sector and can reduce the economy in the long run growth potential.

The major indicators of macroeconomic stability are inflation, unemployment rate, and balance of payment and output growth. The main focus of this article is on inflation, which is the general rise in the price level of goods and services. In Ethiopia wide range of debate has been undertaken regarding the source and impact of inflation in economic growth. Some argue that inflation is the sign of high economic growth while others say it is the symptom of wrong economic policy in the country. Both arguments could not provide a supportive numerical evidence to justify their argument. In order to set realistic and effective policy measures, we should understand the source of inflation with proper analysis. The main purpose of this study is to explain the sources of inflation by using suitable numerical evidence. The article is divided into seven sections. Section two explains the concepts and measurements of inflation. In this section the study explains various measurements of inflation. Section three and four discuss the trends and sources of inflation. The fifth section highlights the link between growth and inflation in Ethiopia. Section six identifies the major challenges of inflation and economic growth. The last section provides the way forward to achieve sustainable economic growth in Ethiopia. For the sake of my reader I present the study in two parts: Part I covers the first four sections. The remaining sections will be covered in part II.

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<sup>2</sup> Macroeconomic stability allows business individual and the government plan more effectively for the long term, improving the quality of investment in physical and human and helping to raise productivity.

## 2. Concepts and measurements of inflation

Inflation is defined as the general rise in the price level of goods and services in the economy. General rise in the price level indicates the net change in the price of all baskets of commodity produced and services provided in the economy. That means there may be an increase or decrease in the price of basket of some commodity in the economy. The net effect gives us the general rise in the price level or decrease in the price level. If the net change is a rise in the price level, we can call it inflation otherwise deflation. There are various methods used to measure inflation. The common methods that are used to measure inflation are:

- Consumer Price Index (CPI): Take the change in the price of consumer good and services.
- Producer Price Index (PPI): Take the change in price of raw material or produce used by the producers.
- GDP-Deflator: It is the ratio of nominal and real gross domestic product.

The types of inflation measurement provide different outcomes with their respective purpose. The CPI measures only the change in the price of consumer goods and services. The CPI assumes fixed basket of commodity. It includes the change in the price of all imported good and service. One of the critic of CPI is it does not include the change in the price of raw materials that are used by producers. In the same way, the PPI includes only the change in the price of raw materials that are used by the producers. On the other side GDP, deflator takes only locally produced goods and services. But most of the time CPI used to measure inflation because it represents the majority of economic actors that is consumer<sup>3</sup>.

## 3. Trends of inflation in Ethiopia

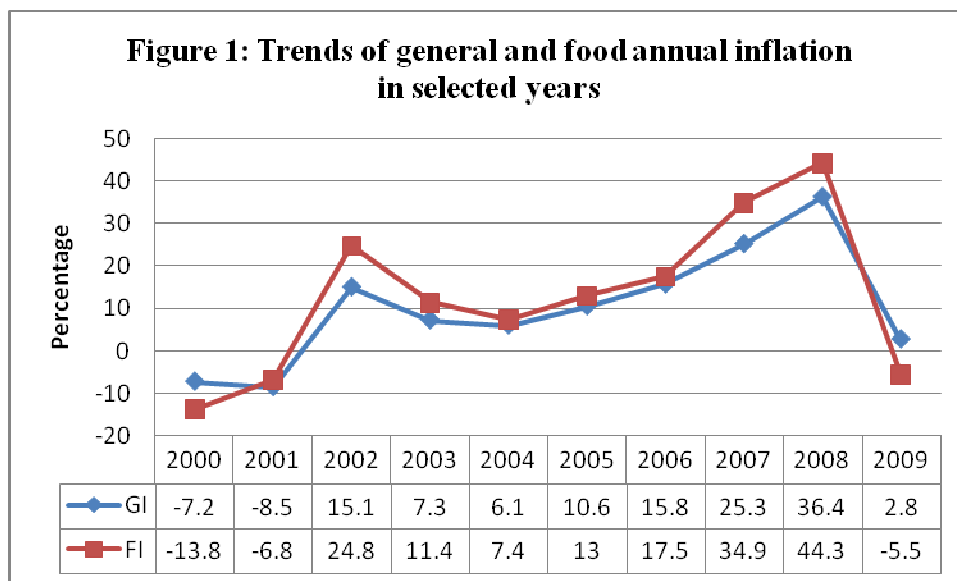
Trends of inflation show the change in the inflation<sup>4</sup> over the years. Looking at the trends of the inflation would enable the reader to understand the change of inflation during the study period over the years. Further it observes what goes wrong or right at a particular year. Regarding inflation, the government and other international institutional reports indicate that the country has been experiencing the higher price rise since 2004. In 2000 and 2001, the inflation rate was negative 7.2 and 8.5 percent respectively. In 2002, the inflation rate increased to 15.1 percent. But the recovery of the agricultural production and general economic growth has reduced the inflation rate to 6.1 percent in 2004. In 2004, the inflation rate declined by 60 percent as compared to 2002. After 2004, the inflation rate could not show any sign of declining till 2008. In 2008, the inflation reached its highest 36.4 percent. Figure 1 below presents the general and

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<sup>3</sup> Everyone can be consumer but everyone can be producer. That why using CPI better measure the impact of the change in the price on the majority of the society than the PPI. In the same way the GDP-deflator cannot consider the change in the price of imported goods and services. .

<sup>4</sup> Unless otherwise mentioned, the study used the annual inflation rate.

food annual inflation rate during 2000 to 2008. The higher inflation since 2004 has an implication for economic growth: reducing consumer purchasing power, exchange rate volatility and reduced investment confidence.



Sucre: CSA, 2010

The debate is not about the impacts of inflation on economic growth rather the sources of inflation in the country. Getting the right source of inflation helps government and civic organizations to design appropriate policy to control inflation and at the same time to keep the current pace of economic growth. For Ethiopia, economic growth is not a matter of choice; we must maintain higher growth to provide our present or future generations need. By any standard for the country like Ethiopia, it is not acceptable to control inflation by the cost of economic growth.

#### 4. Sources of inflation in Ethiopia

Theoretically the source of inflation can be categorized into two broad parts: demand-pull and cost push inflation. The demand-pull inflation arises due to the higher demand for goods and services while the cost-push inflation is due to an increase in the cost of production of goods and services. Or some time inflation may arise due to both demand-pull and cost-push factors. Ethiopia's source of inflation is not out of these major sources of inflation. But the challenge is to locate exactly which source of inflation dominates or takes the higher share. The next sub section presents the factors that contribute for inflation in Ethiopia which are: Higher desire for consumption spending and value of imported material.

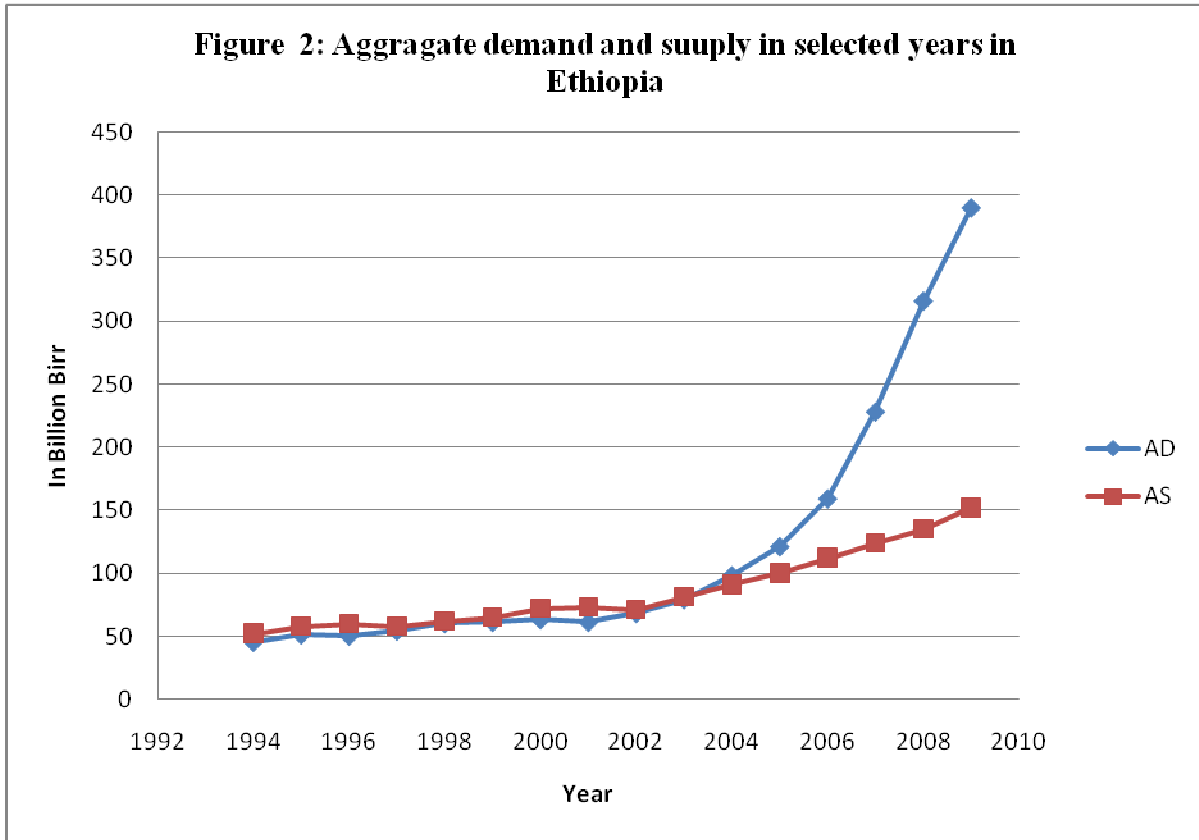
#### **4.1 Trends of aggregate demand and supply in Ethiopia**

Aggregate Demand (AD) refers to the amounts of goods and services demanded by domestic consumers, businesses, government and foreign buyers at a given price level. On the other side Aggregate Supply (AS) is the quantity of goods and services willing and able to sell at the given price. The former refers to all consumers (domestic or foreign) who have desire to spend their money to buy goods and services. The latter represents all businessmen and government involved in the production and distribution of goods and services.

As you can see in the figure below, the amount of aggregate demand (goods and services demanded by the consumer, investor, government and net foreign desire) is greater than the aggregate output produced by the economy. For instance until 2004, the difference between aggregate demand and supply was less. For instance in 2000, the desire to buy goods and services in the economy was only 63 billion Birr. In the same year the value of goods and services produced in the economy was 72 billion Birr. That means the value of output produced in the economy was higher by 14 percent as compared to the desire of the consumer ability to spend. In other words there was demand deficiency. This may be the reason for the 7.1 percent deflation in 2000. After 2004, the situation in the country completely changed.

The desire for goods and services (aggregate demand) started to grow at a faster rate than the value of goods and services produced in the economy. In 2004, the aggregate demand started to exceed the aggregate supply by 7 billion Birr (see figure 2 below). After two years, in 2006, the gap between aggregate demand and supply reached 47 billion Birr. During these two years, the desire for goods and services increased by 58 billion Birr while the value of aggregate supply increased only by 21 billion Birr. In 2008 also, the aggregate demand exceeded the aggregate supply by 181 billion Birr. In other words, the economy produced only 42 percent of the national need (the desire to spend). Both AD and AS were increasing at a higher rate as compared to before 2004, but after 2004, the growth rate of aggregate demand was much higher than the aggregate supply. Between 2004 and 2008, the annual growth rate of aggregate demand and supply was 29.7 and 10 percent respectively. Anybody would guess what will happen if annual growth of aggregate demand exceeded the available supply goods and services in the economy by 19.7 percent. This caused the price to increase at a higher rate than ever before. This justifies the source of inflation in Ethiopia to be due to the higher demand growth in the economy. This type of source of inflation is called demand-pull inflation. One of the conditions for economic growth is level of demand in the economy. The higher demand in the economy should be supported by the proper functioning market and other institution which enable us to manage the higher demand. I do some what support the need for higher demand to create the supply. If there is no demand, the businessperson may not be encouraged to produce new goods and services that improve the welfare of the nation.

**Figure 2: Aggragate demand and suuply in selected years in Ethiopia**



Now the next question is what causes the aggregate demand to grow at a faster rate (29.7 percent) than aggregate supply (10 percent)? What components of the aggregate demand and supply take the higher share of these changes? In Ethiopia's case the change in aggregate demand is highly influenced by the change in consumption spending. On average around 95 percent of the total spending is consumption. The national economy is characterized by high consumption like USA unlike that of Japan that produces more for export. The consumption spending between 2004 and 2008 showed increase by 28 percent. The higher desire for consumption spending was dominated by the private consumption spending than government consumption spending. In 2008, the government consumption spending was only 9 percent of the total consumption spending. The remaining 91 percent consumption spending was taken by private consumption spending. The annual growth rate of private consumption spending during the same was 29 percent, which was higher than the 19 percent government spending.

The government implemented the higher spending during 2004-2008 mainly expansionary monetary policies. Due to this policy change, the domestic borrowing annual increased by 20 percent in the same period. Again the higher domestic borrowing growth rate was for private

(29%) than government domestic borrowing (9.9 percent %). All the above explanation justifies that the increase aggregate demand was one of the reasons for inflation. In this regard the higher private domestic borrowing and consumption spending contributed for the growth of aggregate demand. In such kind of descriptive evidence, any measure that reduces government spending has negative implication for economic growth. The problem is not the amount of government spending used for social and infrastructure development, rather it was on diverting the higher private consumption spending to productive spending to increase capital formation and output growth in the country.

**Table 3: Annual growth rate of government, private and capital formation spending and borrowing**

Year	GCP <sup>5</sup>	PCS <sup>6</sup>	TCP <sup>7</sup>	CFS <sup>8</sup>	Borrowing		
					Private	Government.	Total
2000-2003	4	11	21	12	3.5	9.2	4.5
2004-2008	19	29	10	27	29	9.9	20
2000-2008	13	22	28	20	22	11	16

Source: MoFED, 2009

#### 4.2 Imported source of inflation

Ethiopia exerted its efforts since 1992 to join the world economy by introducing various trade liberalizations and other related reforms. The growth development appetites in the country increased the demand for import. Although the export did not increase proportional to import, the export sector showed a significant change during the last ten years. The main focus of this sub section is to show the relationship between the change in imported amount and value of import items and inflation in the country. It takes the main important imported materials as a main factor, which partly represents the change in the price of, imported items during the study years. The value and amount of imported items included are chemical, fertilizer and petroleum production.

The figure 3 below shows the variation between the amount and value of imported items. Before 2000 and 2003, the annual growth rate of the amount and value of imported items was

<sup>5</sup> GCP Represent Government Consumption spending

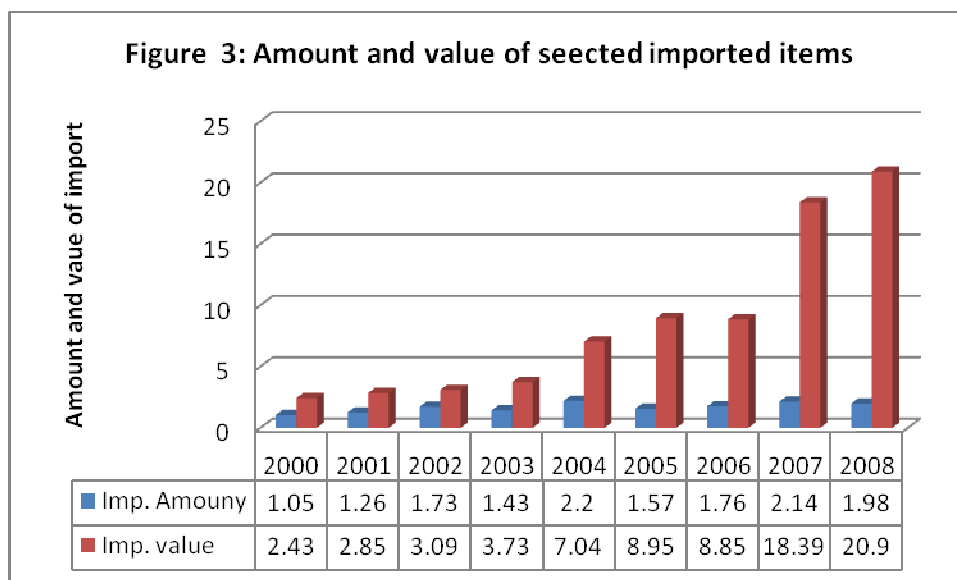
<sup>6</sup> PCS Represent Private Consumption spending

<sup>7</sup> TCS Represent Total Consumption Spending

<sup>8</sup> CFS Represent Capital Formation Spending

proportional. During these years, both amount and value of import items increased by 12 and 13 percent respectively. The value of imported items increased from 7 billion Birr from 2004 to 20 billion Birr in 2008. In the same year the amount of import was decreased from 2.2 to 1.98 million metric tons. In this period, the amount of chemical, fertilizer and petroleum production imported increased only by 1 percent. But value of the same imported items increased by around 29 percent. Imagine the economy was paying 28 percent extra for the same amount of item the country imported between 2004 and 2008. This was not the situation before 2004. From this analysis, anybody can understand the source of inflation in Ethiopia. Without any change in the demand of import items, the value of imported items increased by 28 percent. Such change in the imported price affected the inflation at least by 28 percent in addition to other multiplier impact of the rise in the price of imported items: reducing foreign reserve and change in the price of other goods and services. The higher increase in international price, devaluation of local currency and other factors has forced the country to pay more for less for the same amount of imported items.

In this case the solution not to advice to cut government spending, rather than reduce the country's dependency on import. The private sector and the government must work hard on selected Import Substitution Strategy (ISS) to minimize the increase in the value of imported items.



Source: NBE, 2009

Part II will come soon

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