Why is the World Bank Bothering the Government of Ethiopia on Devaluation?

It appears quite puzzling that international financial Institutions (IFIs) such as the World Bank that are supposed to help the development of African countries such as Ethiopia offers them unreasonable advise (or shall I say order) when these governments are actually doing the right thing. In this brief article I will argue that the government of Ethiopia's exchange rate policy stance is very good form four angels. I will then hope that our readers and governments will be critical of some of the advices that come from international financial institutions such the World Bank, the IMF, WTO and the like.

It is commendable to hear these days that the World Bank and the IMF offices in Ethiopia are arguing for more private sector role in the Ethiopian economy. In fact the government seems to take itself as the only one that can bring about development in the country. That is outright wrong and a pressure from the IFSs in that regard is a very welcome thing. However, when they come with a policy such as devaluation at this juncture in the country's history, which is not even a friendly policy to the Ethiopian private sector in today's Ethiopia, we need to stand with the government and argue out with them as that policy is not compatible with the welfare of the Ethiopian people and Ethiopian national interest at large.

The Bank argues that the Ethiopian currency is unduly expensive in terms of foreign currency such as the US dollar. In the economic jargon we call that over-valuation of exchange rate. In lay man terms, the World Bank's advice says " the Birr 19.60 that you Ethiopians are giving when somebody comes with 1 US dollar to your country is too small; so please give them instead 22 Birr (10% increase) or 24 Birr (20% increase) for the same dollar". If you do so, the Bank argues, your importers are discouraged to import because it will be expensive to them in terms of the local currency/Birr/. In addition, the Bank says, your exporters will be encouraged because they will get more money in terms Birr for the same 1$ dollar export item they send abroad. Not only that, the Bank continues narrating, investors and those who send money to Ethiopia will be attracted by this good deal and will send more money and invest a lot. When that happens, you will be able to narrow down the gap between your imports (which is close to 11 Billion US$) and your exports (which is just under US$3 billion) which is about US$8 billion per year.

No question this is a huge foreign exchange deficit; however, despite this pressure from the Bank,, the Ethiopian government is moving with its exchange rate policy (referred by economist as crawling peg/or managed floating). This policy means that the government doesn't completely leave the exchange rate to be determine by the 'free' market of demand for and supply of foreign exchange in the country – ie. it will manage it. Without going to detail technical analysis, I argue here that the government policy is right and the World Bank's pressure is wrong for the following four basic reasons.

First, Ethiopian imposts are what can be described as strategic imports which are not amenable for reduction because they will be expensive in local currency following the advised devaluation. The breakdown of our imports shows that about 70% of our imports are capital & intermediate goods, fuels and related imports which we will be importing whether they are expensive or not and hence the wrong presumption of the Bank. In fact, if they came to be expensive in local currency they will lead to inflation which the government has tried its best to abate it in the last two years. Moreover, since the government is a major actor in the economy its own import bill will be very high and will enter into budget deficit which invariably leads to inflation in Ethiopia. This will take me to my second argument.

The second argument against devaluation in today's Ethiopia is its inflationary consequences. Myself and my former student's empirical research and forecast on Ethiopian inflation shows (and actually our forecast proved right in the last devaluation in 2010) that a 20% devaluation in Ethiopia will have an effect of about 40% increase in inflation. Given the Ethiopian traders capacity of passing such an increase in price to consumers which is found in the same study, this will have a detrimental impact on the welfare of the population (especially the poor). In addition, given the low level of foreign inflation this might even lead to appreciation of the Ethiopian currency and possibly contraction of business activity due to the rise of cost of inputs and low real demand that may emanate from this policy. This is what progressive economist call "contractionary effect of devaluation" which was very common in Latin American countries in the 1980s and 1990s.

The third argument against the devaluation advice relates to the fact that Ethiopian exports will not dramatically increase or may not increase at all because of devaluation, as the Bank presumes. This is because the fundamental problem behind Ethiopian exports is not a need for a rise in price (note that devaluation here acts as a rise in price because exporters get more money in terms of birr for the same export) but rather major hindrances to supply/production and exporting. My and my colleagues survey based research on problems of Ethiopian exporters (we took a sample of 100 exporting firms) found that their fundamental problems in order of importance are: (i) access to land, (2) customs, tax regulations, tax rates and administration, and (3) corruption. More than 70 per cent of the exporting firms rated access to land as the major obstacle for their operation. In addition a more structural problem to Ethiopian exporting firms is the lack as well as inadequacy of infrastructure. Though encouraging improvements are reported in road, air transport, and telecommunication services, about 70 per cent of the exporting firms reported such infrastructure as well as telephone and communication deterioration as major problems. The other important factor is access to finance, which is constraining firms from operating at full capacity. Exporting firms exhibit considerable level of inefficiency with an average capacity utilization rate of around 55%.It is interesting to note in passing that the Bank's own studies on Ethiopian firms revealed similar findings to ours. I think addressing these problems, not devolution, is the key to leapfrog our exports. I think I need not to say that our brothers and sisters abroad will send more money to their families in Ethiopia because a dollar fetches more birr now and so is foreign direct investment (FDI).

Fourth, perhaps more importantly, the World Bank suggestion seems to send a signal that the Ethiopian government could wake up just one bright day morning and change the exchange rate (I would not so much blame the Bank in having this perception because the Ethiopian government has made this mistake in its last devolution of about 20% in 2010 – that shouldn't have been done). However, today this perception incredibly damages the policy credibility of the government. It is imperative both for Ethiopian and foreign business community that the government's policy on such sensitive issues as devaluation, inflation etc should be predictable and credible. This is because business people plan their activity with such credible policy stance in mind. A small business man friend of mine has lost over 500,000 birr in the last devaluation just in one day, I know also a big car assembly plant that went to deep crisis owing to the 2010 devaluation and inflation, among other things. Thus, if needed the government need to stick to its crawling-peg/managed floating policy stance and make changes in piecemeal and predictable manner as it is currently doing; otherwise, inter alia, business people may began planning in US$/Euro/Pound instead and government could lose monetary policy power as a result –Zimbabwe being a case in point that lost total monetary policy control today and its currency is replaced by dollar/Rand.

In short the Ethiopian balance of payment problem is structural not financial; and hence need structural, not financial solution. That may leave you wonder what the interest of the IFIs/WB is to advise for devaluation when they are supposed to help African country's endeavor in having credible macroeconomic management. However, a historical excursion to the history of the Bank macro policy in the last four decades in Africa which remained fundamentally unchanged from the days of SAPs (Structural Adjustment Policies) to enhanced SAPs and the current PRSPs (poverty reduction strategy papers) despite the name change should say something about the nature of such IFIs..

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