Trade Liberalization, Poverty and Inequality in Ethiopia

Alemayehu Geda   (Addis Ababa University and IAES)
Abebe Shimeless   (Formerly Gutenberg University and IAES)

IAES Working Paper

Corresponding Author: Alemayehu Geda at   AG112526@gmail.com or AG@iaesafrica.com

Mission

The Institute of African Economic Studies is (IAES) is an autonomous none-governmental research and training institute whose primary mission is to provide quality, research-based, policy advice to the governments, regional and continental organization, development partners and the private sector in order to contribute to achievement of national, regional and continental development goals. It has also a consultancy wing that works based on the commercial code of Ethiopian and licensed from the Ministry of Industry. The Institute contributes to improved public policy making and implementation by:

Conducting objective policy research and analysis; Informing and providing advice during policy-making process; Building capacity of the Governments of Africa to absorb, undertake and analyze public policy; Strengthening working modalities with the Governments of Africa and other stakeholders; and Enhancing government ministries capacity through on-job training in order to effectively support the policy process.

The IAES is therefore a central source of information and research-based advice on a wide range of policy issues.

The IAES Working Paper Series Presents Work in Progress by Research members and Associates of the Institute. The aim is to solicit comments. The views express in the Working Paper are the views of the authors and not necessarily that of the IAES

1.   Introduction

Poverty reduction is the core objective of the Ethiopian government. Economic growth is the principal, but not the only means to this objective. In fact in the second generation PRSP, called: the PASDEP (Program of Action for Sustainable Development to end Poverty), which is effectively the latest five-year plan of the government, trade policy is taken as one of the fundamental tools that will be used to realize its objective of poverty reduction. This policy approach raises fundamental questions: 1) what are the mechanisms and conditions by which trade translates into poverty reduction? 2) how do initial poverty and inequality affect the prospect for sustained and rapid economic growth that is triggered by trade policy? And, 3) what are the links among trade, economic growth, income distribution and poverty. This paper is aimed at addressing these questions.

The pattern of growth in Ethiopia, based on data for the last four decade, can be characterized as erratic. This is greatly related to the vagaries of nature (which affects the performance in the agricultural sectors) and other external shocks –trade, aid and conflict (See Alemayehu, 2010). In the context of Ethiopia, the evidence on the pattern of poverty and inequality over the decade obtained from the national household income and consumption surveys, as well as the panel data of the Department of Economic of Addis Ababa University, indicate that it has been clearly rising in urban areas, and remained more or less stagnant in rural areas though it exhibited considerable variation across time according to the panel data (See Table 1, Alemayehu et al, 2008).

Table 1: Trends in poverty and inequality in Ethiopia: 1994-2004

	National Data			Panel Data				
	1995/96	1999/2000	2004/05	1994	1995	1997	2000	2004
Headcount ratio								
Rural	48	45	39	48	40	29	41	32
Urban	33	37	35	33	32	27	39	37
National	46	44	39	46	39	29	41	33
Gini coefficient								
Rural	27	26	26	49	49	41	51	45
Urban	34	38	44	43	42	46	49	46
National	29	28	30	48	48	42	51	45
Growth*	10.6	5.9	10.3	6.2	10.6	-0.5	7.2	10.3

Source*: Alemayehu et al (2008)*
* is the Official GDP (Macro) growth rate at constant market price of 1999/00 (1995 is also taken as 1995/96 in the Panel data growth figure of last raw)

The growth and poverty profile noted above is observed following liberalization in general and trade liberalization in particular that began in 1992. Thus, it is instructive to see how trade policy, such as trade liberalization, has affected the level of poverty and inequality in Ethiopia, one of the channels being through the nature of growth.

The trade-poverty linkage could be conceptualized using Figure 1 below. There is a wide literature on the impact of trade policy such as trade liberalization on poverty. Diagram 1 shows how the relationship between trade liberalization and poverty is conceptualized in this study. We hypothesized that trade liberalization affects the level of poverty directly through its effect on prices and hence income (prices of exports and or real exchange rate) as well as through raising productivity which in turn is the result of imports of productive assets or new technology such as the green revolution. As Ben-David et al (1999) noted, more important than price changes is whether markets exist at all: trade reform can both create and destroy markets. Opening up the economy will

often reduce risk and variability because world markets (which have many players) are more stable than domestic ones. But sometimes it will increase risk either because official stabilization schemes are undermined or because residents switch completely from one activity to another that offers higher average rewards but greater variability. In these cases economic vulnerability could increase, which could increase the incidence of poverty even as the average incomes of the poor increase. (See Ben-David et al, 1999). Similar vulnerability and poverty may also ensue if the main stay of the economy is based on rain-fed agriculture limited commodity export which is vulnerable to climate change and world market conditions – as is the case in Ethiopia.

Trade has also indirect impact on poverty through its effect on the nature growth - related effect on distribution of income. That is, there are distribution neutral growth, equal distribution growth and unequal distribution growth. Each of these has different effect on poverty since poverty is normally positively related to growth but this growth may lead to inequality which may increase the incidence of poverty. In short, the key to sustained poverty alleviation is economic growth. While growth may not benefit everyone in an economy, the benefit from the growth process must be strongly biased to the poor to reduce poverty (See Ben-Davit et al, 1999; Alemayehu et al, 2008).

Diagram 1: The map of the effect of Trade liberalization on poverty
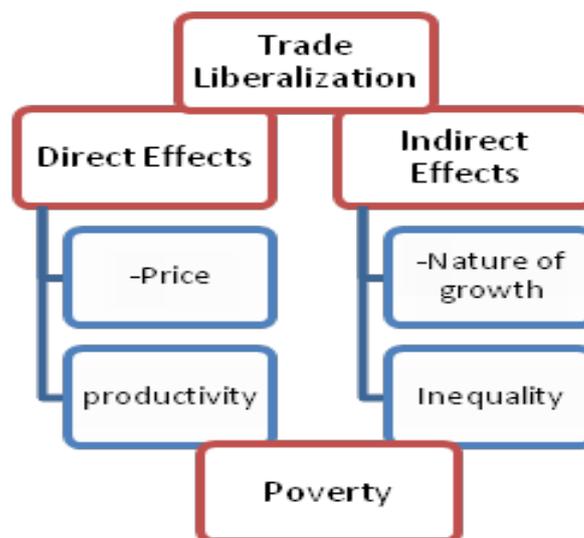
We have used this conceptual framework to see the relationship between trade liberalization (whose proxy is openness or engagement in the traded sector) and poverty. This is done both for Africa in general and Ethiopia in particular. The African literature is emphasized to shed light some ambiguous results when the Ethiopian evidence is examined.

2   Trade Liberalization, Poverty and Inequality in Africa: The Literature

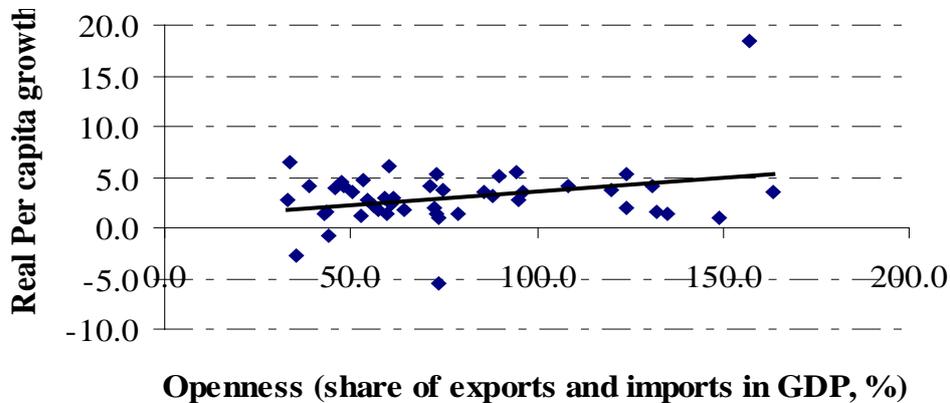### 2.1   Trade Liberalization, Growth and Poverty in Africa

The literature on trade policy (invariably trade liberalization) and growth has emphasized the notion that trade liberalization/openness strongly impacts growth. Dollar (1992), Ben-David (1993), Sachs and Warner (1995), Edwards (1998) and Frankel and Romer (1999), using different measures of openness/trade, noted openness is significantly and positively associated with economic growth. This assertion however, is not without its critics (see, for instance, Rodriguez and Rodrik (2000), Dixit (1988) and Calvo (1987, 1988) who have also contested the conclusions of the afro-mentioned studies (cited in Collier and Gunning 1996).

Rodrik's various works questioned the uncritical acceptance of the importance of openness (see Rodrik 1992, 1999, 2001). He debated whether the measures of openness used in the influential articles cited above focused solely on trade policy issues. In Rodriguez and Rodrik (2000), the authors made it abundantly clear that the openness measures used in much of the empirical literature did not really select trade policy indicators as such. Therefore the finding that openness matters for growth could be spurious. Rodriguez and Rodrik (2000), after critically examining the main finding of these influential pro-openness studies, noted that this literature is largely uninformative regarding the question of "do countries with lower policy-induced barriers to international trade grow faster, once other relevant country characteristics are controlled for?" They noted that there is a significant gap between the message that the consumers of this literature (including multilateral institutions) have derived from it and the 'facts' that the literature actually demonstrated. This gap emerged from: (a) the researchers use of 'openness' indicators that serve as poor measures of trade barriers or are highly correlated with other sources of bad economic performance; and (b) the methods or empirical strategies used to ascertain the link between trade policy and growth. Thus, these methods have serious shortcomings and their removal results in significantly weaker findings.

The main point made by Rodriguez and Rodrik (2000) is that some of the commonly used openness indicators serve as a proxy for a wide range of policy and institutional differences, and they can give biased results that do not properly evaluate the effect of trade policies on growth. The authors however, were in no way suggesting pursuing trade restrictions. They underscored that, "what we would like the readers to take away from this paper is some caution and humility in interpreting the existing cross-national evidence on the relationship between trade policy and economic growth" (Rodriguez and Rodrik, 2000: 62). For instance, in the case of Sub-Saharan Africa, as noted in Rodrik (1998), there is little concern that Africa's different conditions such as poor infrastructure, geography or dependence on few commodities, make it a special case where exports do not respond to liberalization policies. However, he argues, the effect of trade policy on economic growth seem to be indirect and much more modest. This is because the fundamentals for long term growth -- human resources, physical infrastructure, macroeconomic stability, and the rule of law -- are relatively underdeveloped in the continent (Rodrik 1998).

These studies draw attention to the difficulty of defining openness with reasonable indicators (see Fosu 2000 for a discussion). Various measures are used, including exchange rate overvaluation, relative price distortions, tariffs and quotas, share of trade in GDP, and the parallel market premiums rate. According to Fosu's survey, the most comprehensive measure of openness appears to be the one used by Sachs and Warner (1995)[1]. Be that as it may, Figure 1 shows the positive, not that strong though, relationship between openness (trade liberalization indicator) and growth for a sample of African countries.

---

[1]   For Sachs and Warner, an economy is deemed open if (1) average tariff rates are below 40 per cent; (2) average quota and licensing coverage of import is less than 40 per cent; (3) a parallel market exchange rate premium is less than 20 per cent; (4) no extreme controls (taxes, quotas, state monopolies) on exports exist; and (5) the country is not considered a socialist country (See Fosu, 2000: 3-4).

Figure 1: Openness and Growth in Africa 1990-2001

Openness (share of exports and imports in GDP, %)

If trade liberalization leads to growth the next important question relates to whether this growth could be translated to poverty reduction. In a sense this is a question of the nature of growth that is triggered by trade – is such growth pro poor? This question brings us to the next important issue in the literature – the relation between trade liberalization and poverty in Africa.

To say that poverty is pervasive in Africa is perhaps to state the obvious. Poverty in Africa is generally found to be a rural phenomenon, and in most countries, urban poverty is lower than rural destitution by as much as 50 per cent, suggesting significant regional disparities in the standards of living1990s and first half of the new century . During the 1990s, the number of poor living in SSA increased by about 73 million, leading to a one percentage point rise in the incidence of poverty (see Table 8). A recent report by the ECA (2003) noted that close to half of the African population lives on less than a dollar per day. However, a comparison of two surveys conducted for about 14 countries in the early and late 1990s shows that there may be a trend towards poverty reduction (see Alemayehu and Abebe, 2006).

The economic growth that stems from international trade is one effective means available to Africans for tackling poverty if it is found to be pro-poor growth. It is therefore important to ask whether poverty in Africa is associated with greater openness in general, and trade liberalization in particular. However some literature shows that openness is also associated with inequality (see Cornia, 1999 for instance). Cornia (1999) argues that falling equality in Africa over the past two decades cannot be attributed to the traditional causes such as land concentration and unequal access to education, but rather to the adoption of the unregulated liberalization of domestic and international markets. His analysis points out that inequality between countries has been, in the past 15 – 20 years, followed by a surge in inequity within countries, including a few African economies. According to Cornia, the main source of the disparity in Sub-Saharan Africa was the urban-rural gap. However, the process of 'equalization-downwards', with the impact of failed structural adjustment (liberalization) policies on urban income, has bridged that divide. Cornia also noted that intra-urban and intra-rural disparities have persisted as a result of policies that promote growth and exports in the midst of highly unequal distribution of assets. Given these findings, it seems that the relationship of openness, growth and inequality remains undetermined. The question arises then; does this mean that more openness can lead to a worsening of income inequality and higher incidence of poverty, even if it has positively contributed to growth and hence poverty reduction? The answer depends on a number of factors. There are cases where increased trade liberalization might be beneficial to the

poor. According to Winters, McCulloch, and Mckay (2004), the net gain to household welfare could be positive in circumstances where the majority of the population works in the tradable sectors, such as in the production of exportable crops or in the formal manufacturing sectors that trade internationally. The entire issue is thus country and period specific.

Notwithstanding the complex relationship between trade, growth and poverty, in particular where the effect of income distribution is considered, the aggregate available data for Africa in the 1990s shows that openness (trade liberalization) is negatively associated with the incidence of poverty. The relatively developed countries such as those in North Africa, South Africa, Cote d'Ivoire had a high index of openness and a lower incidence of poverty (see Figure 3a and 3b). Botswana, which is an outlier, did not seem to have less poverty even though it maintained a higher degree of openness. This case suggests the possibility of a non-linear relationship between the two variables. This outcome might be related to inequality which often arises (or increases) in highly open countries characterized by dependence in a single commodity; such as diamonds in Botswana (see Alemayehu and Abebe, 2006, for detail).

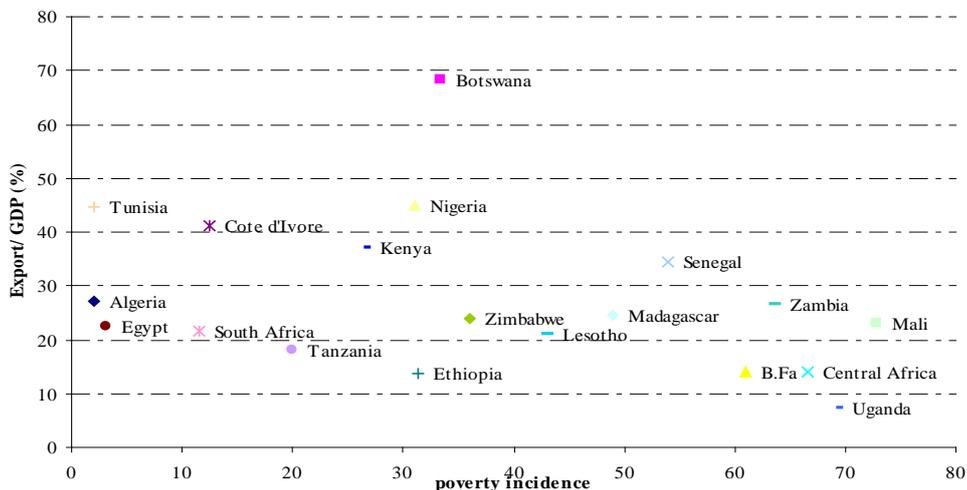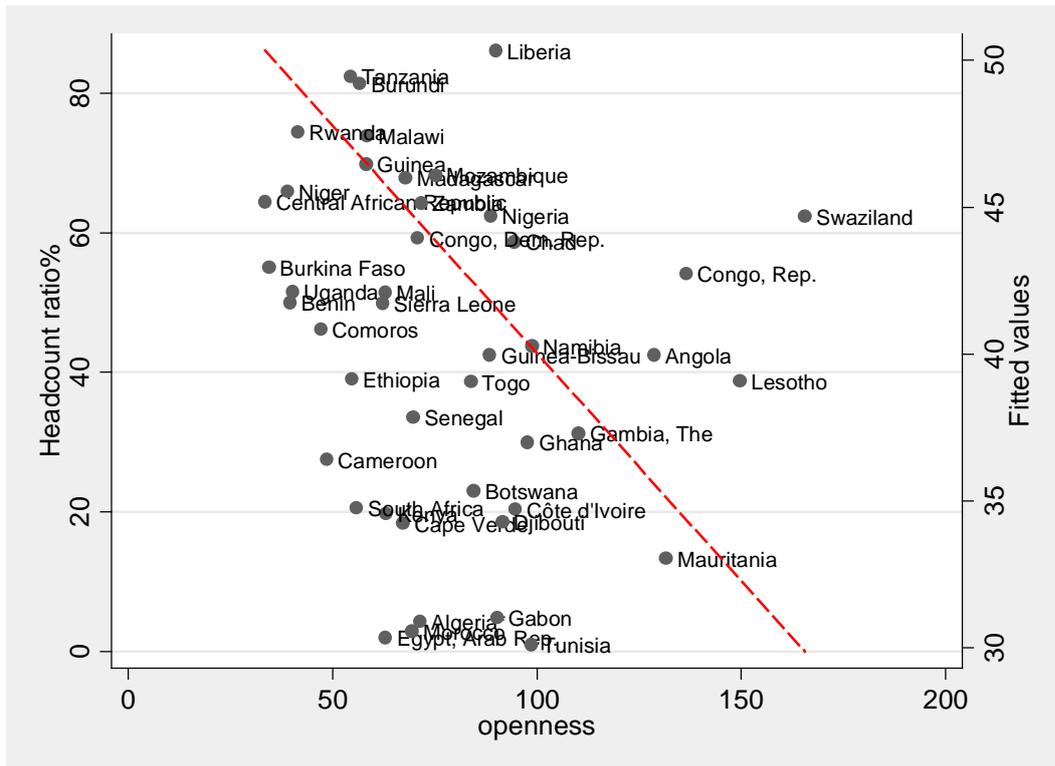Figure 3a. Openness and Poverty in Africa in the 1990s (using only Exports)

Figure 3b: Extreme poverty and volume of trade in selected African countries in 2005 (using Exports and Imports)

Notwithstanding this negative relationship, it is worth noting that the relation, in particular using recent data for the year 2005, may be much more complicated than a simple negative relationship. As can be read from Figure 3b, although one may fit a negative linear trend for the scattered plot it is also plausible to fit a quadratic high parabola to the data. In this latter formulation the quadratic form is the result of a possible positive relationship between openness and poverty for island and small economies such as Lesotho and Swaziland. Openness might also be related to increasing inequality which in turn worsen poverty, to which the next sub-section is devoted.

2.2 Trade liberalization and Inequality in Africa

The earlier literature written by Africans took the extreme view of openness as one of the major obstacles hindering development in the continent[2]. One of the widely cited earlier ECA publications (ECA, 1989), 'The African Alternative to Structural Adjustment', noted that weaknesses in Africa's productive base, the predominant subsistence and exchange nature of the economy, and its openness (to international trade and finance) have all conspired to perpetuate the external dependence of the continent. According to ECA (1989) the dominance of the external sector is one of the striking features of the African economy; one that leaves African countries quite vulnerable to exogenous shocks (ECA, 1989). However, other recent analysts (see Collier and Gunning 1999) argue that "*lack of openness* explains why Africa has grown more slowly than other regions". Thus, one way of contributing to this debate is to examine the pattern of trade, (and also finance) and poverty in Africa.

Although global interdependence takes the form of both finance and trade, the focus here is on trade liberalization because of our objective in this paper and also Africa's under-developed financial

---

[2]   See Alemayehu (2002: Chapter 1) for a discussion of such studies.

sector and its relative isolation (apart from aid) from global financial markets.[3] Africa's trade, though very small from the rest of the world's point view (SSA share in world exports being about 2 per cent), is dominant and vital, from the African perspective. Trade share in each country's GDP averages above 50 per cent. The empirical literature identifies various channels through which trade liberalization has impacted Africa, including levels and composition of investment, household welfare, the distribution of income, and the competitiveness of local firms, which are briefly surveyed below..

To begin with, one of the avenues through which trade liberalization can affect growth and poverty is through investment. Collier and Gunning (1996) noted that the literature does not unequivocally concur that trade liberalization positively affects aggregate investment. They examined this issue in African context much like Buffie (1992), who argued that if the protected imports substitutes sector is capital intensive then trade liberalization will reduce the returns on investment. Liberalization is tantamount to a reduction of subsidies on such capital goods.

Collier and Gunning (1996), based on the case of Uganda, Nigeria and Tanzania, suggested that trade liberalization might result not only in a fall in aggregate investment, but also changes in its composition. Dividing investment into equipment (tradable capital) and structure (non-tradable capital), they found that in each country, equipment investment fell significantly both in absolute and relative (to GDP) terms following liberalization. For instance in Uganda, equipment investment fell by 20 per cent while structures investment rose by 34 per cent. The authors underscored the need to weigh these opposing changes to analyse the effects of trade liberalization on investment and its composition. If the traded sector is characterized by dynamic externalities and learning by doing, as is usually the case, the detrimental effect of liberalization on Africa's growth could be very large. Changes in investment might also be related to the terms of trade. Liberalization in Africa has led to specialization in commodity production, which has been characterized by a deterioration in the terms of trade and price volatility (see Alemayehu 2002). Along the Prebisch-Singer hypothesis, this volatility in the terms of trade brought about capital (and hence investment) instability in Africa (see Fosu 1991). This will definitely affects the distribution of income.

Another area of concern for African countries is the effect of liberalization on household welfare. An UNCTAD (2004) study shows that there is a general tendency for the incidence of extreme poverty to be more persistent in commodity dependent countries, such as those in Africa, following trade liberalization. In least developing countries that export minerals, the incidence of $1/day poverty rose on average from 61 to 82 per cent between the period 1981-1983 and the period 1997-1999 (UNCTAD 2004: 131). Haousa and Yagoubi (2003) investigated the response of demand elasticities for labour to trade liberalization in Tunisian manufacturing industries. They found weak empirical support for the claim that trade liberalization leads to an increase in the demand elasticity for labour, and they attributed this to the tight labour regulation in Tunisia. This findings indicates the possibility of mitigating the detrimental effect of liberalization on welfare, but only at the cost of firm efficiency and competitiveness, as the demand for labour is found to be weak.

Another study on Tunisia by Chemingui and Thabet (2001) using a Computable General Equilibrium (CGE) model, found that liberalization, and specifically the reduction of export subsidies in the agricultural sector, decreased average rural household welfare. The study attributed this result to a shift in domestic demand from locally produced goods to imported goods, and to a shift in supply from production for local markets to production for foreign markets. The elimination of internal support (subsidies) for agricultural sectors made agricultural inputs expensive. This rise in price forced suppliers to allocate resources for production that used less of the previously subsidized

---

[3]   See UNCTAD (2004) for a detailed discussion about 'trade policy in general' and 'trade liberalization' in particular and Alemayehu (2002, 2009) for both trade and financial linkage of Africa with the result of the world.

inputs. The authors found that rural households will bear the harsher consequences of these changes as both their income are negative affected and their expenditure increased.

The impacts of trade liberalization on urban households have also been the subject of much debate. For instance, Litchfield, McCulloch and Winters (2003) found that trade liberalization hurt non-agricultural households while the effect on rural farmers was dampened by the combination of output and input market reforms. The idea that urban households will be affected, but only through a change in their level of expenditure, appears to contradict the study of Bussolo and Lecomte (1999). The latter authors demonstrated that in Sub-Saharan Africa, a reduction of average tariffs from 40 per cent to 10 per cent entails a real income loss of 35 per cent for urban employers and 41 per cent for recipients of trade rents, compared to a gain of 20 per cent for farmers. The overall net gain for the economy is estimated at 2.5 per cent. As noted by Chemingui and Thabet (2001), the relatively small size of this efficiency gain, compared to the redistribution effects, makes trade liberalization difficult for policy makers to pursue.

In a similar vein, Blake, McKay and Morrissy (2000) concluded that trade liberalization[4] has modest positive welfare effects. These authors noted that the welfare of agricultural producers has significantly improved, although the urban self-employed stood to gain more from freer trade. Ingco (1996), using data from a sample of developing countries, including those from Africa, noted that trade liberalization in agriculture has invariably led to a terms of trade deterioration. This result can be counteracted however, with reforms that correct for domestic distortions. The terms of trade gain and loss is mixed for most African countries in his sample. For net beverage exporters, however, Ingco (1996) observed a loss in terms of trade. He also observed that welfare losses are associated with the extent of initial trade distortion. The larger this distortion, the greater the welfare loss will be. Given the distortions in many African countries, welfare losses following liberalization, thus, are likely to be the dominant effect.

A number of negative impacts of trade liberalization on household welfare are documented in the review of Winters and others (2002) . In the case of Zambia, trade liberalization distorted domestic marketing arrangements and eventually destroyed markets. For instance, the maize marketing monopsony that benefited rural households by allowing them to purchase large stocks of maize was abolished. The loss of the monopsony isolated rural households and significantly reduced their income. (Winters cited in Winters and others , 2002). Deininger and Olinto (2000, cited in Winters and others 2002), using micro-panel data for farm households in Zambia, found that the improvement of agricultural productivity, following trade liberalization, was severely constrained by the absence of key productive assets. In related studies (see Winters and others 2002). Elson and Evers (1997 cited in Winters and others 2002) noted that in a response to commercialised agriculture, many households in Uganda shifted from the production of food crops to cash crops, jeopardizing family health in the process. Their study shows that the adjustments elicited a positive supply response, but at the same time, increased demands on female labour time, and this was accompanied by increases in child malnutrition (see Alemayehu and Abebe, 2006).

There are also studies that point to gains in household welfare following liberalization. Delgado and others (1998, cited in Winters and others 2002) showed that an additional dollar of new farm income raises total household income by $2.88 in Burkina Faso, $1.96 in Niger, $2.48 in the Central Groundnut Basin of Senegal and $2.57 in Zambia. These increases in household incomes, Hazell and Hojjati (1995, cited in Winters and others 2002) argue, are due to the high marginal propensities to consume out of local non-tradable goods. Furthermore, Löfgren (1999, cited in Winters and others 2002), made the case that reduced agricultural protection in Morocco was bound to have substantial welfare gains in aggregate terms. Similarly, Anderson and Yao (2003) demonstrated that the welfare

---

gains accruing to SSA region from participating in the WTO rounds are twice as much than from not partaking in it.

Using data for 14 countries, Hartel and others (2003) concluded the impact of trade liberalization on different households can't be conclusively determined because the effects found were fairly varied and not always positive. It was also observed that global trade liberalization had the unwelcome effect of raising the price of staple foods relative to non-food prices. Since the poor spend a disproportionate share of their income on food, trade liberalization will adversely impact them. Moreover, the impacts of short- run earnings are fairly mixed. With agricultural profit rising and non-agricultural profits and wages falling, the overall outcome depends on the structure of poverty in each country. These results are also reproduced in Hertel and others (2002).

The loss in terms of welfare for Africa may also come, as noted by Dembele (2001), from the global unfairness of trade liberalization. Though most developing countries reduced import tariffs to less than 20 per cent and removed non-tariff barriers altogether, developed countries have not implemented their same commitments. This unevenness in liberalization has caused cheap imports (including from newly industrializing Asian countries) to flood Sub Saharan African markets. This has resulted in the destabilization of many small scale private and public enterprises, and the subsequent loss of a considerable volume of domestic jobs. This trend of de-industrialization, as noted by Dembele (2001), has been accompanied by the repealing of minimum wage laws, which, although aimed at helping competitiveness, have severely reduced the bargaining power of employees. Currency devaluations and loss of revenue from import taxes have diminished purchasing power, with governments forced to respond to budget deficits with new indirect taxes. The result is more pressure on low income families, which tend to spend most of their income on consumption, and cutbacks on important public, especially social, spending.

Tekere (2001) similarly reported that liberalization in Zimbabwe put the country's economy in turmoil, and that growth was better in the years preceding liberalization. According to Lall (1999, cited in Winters and others (2002)), the increased import competition in Africa has substantially reduced industrial employment. Rather than upgrading aggressively, firms in Kenya, Uganda and Tanzania contracted in its activity in response to competitive pressure. Lall (1999) noted that firms' lack of preparedness for competition, the absence of policies to promote technological improvement, and the poor technological and infrastructure development in the countries, were thought to have contributed significantly to these perverse results. A similar study by Parker, Riopelle and Steel (1995, cited in Winters and others 2002) showed that the benefits from import-liberalization accrued mainly to firms that modified their operations swiftly.

It might be instructive to wrap up the distributional implications of trade liberalization with Rodrik's (1992) observation and finding, which is quite relevant to Africa. He noted that the impetus for liberalization in Latin American and African countries primarily arose from the prolonged macro-economic quagmire in which developing countries were immersed during the 1980s. The liberalization pursued has generally led to five dollars of income being reshuffled within the economy for every dollar of efficiency gain. This huge distributional effect has an enormous political implication. Considering three parties: consumers, domestic producers and import license holders, he showed that license holders and domestic producers lost portions of income while consumers gained by a magnitude that barely exceeded these losses, leaving a net efficiency gain that amounted to a fraction of the losses of the two parties (i.e. the ratio of net gains to redistribution that is involved is very small). Although there are studies that support the view that trade reform improves equity, the prospect of too much redistribution may explain the political difficulty in enacting trade reform. From the perspective of policymakers, the study elaborates that the pure reshuffling of income must be counted as a political cost. The rents and revenues that accrue on a

regular basis create entitlements, thereby increasing the political difficulty of instituting changes except, perhaps in times of crisis. It is thus instructive and important to appreciate the political context of such reform, particularly in Africa where the democratic tradition is generally nascent.
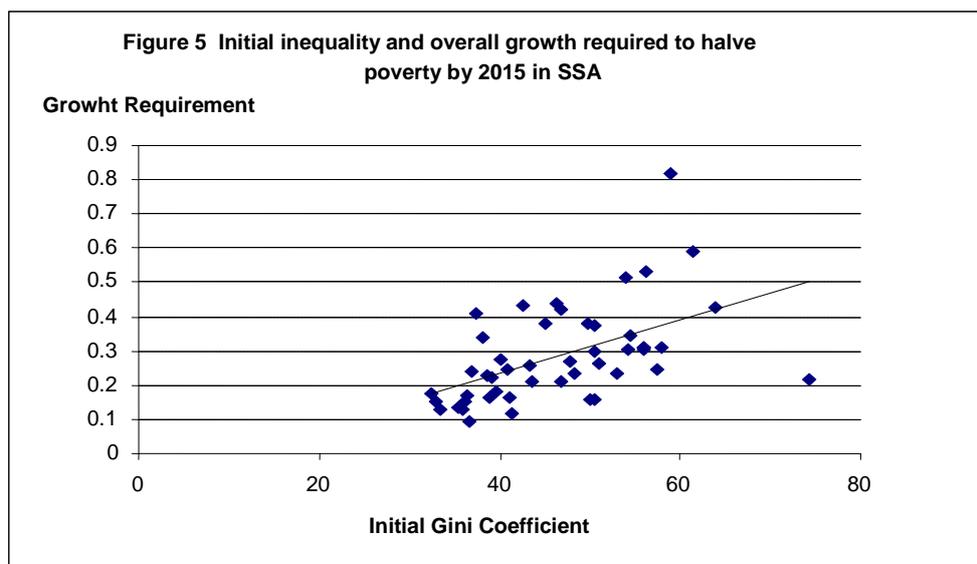
The available aggregate data in Africa shows that (see Figure 4) openness (measured as exports and imports as the share of GDP) is positively associated with income inequality. This data indicates that more open economies in Africa tend to have high levels of income inequality. Part of the reason for this positive association could be that Sub-Saharan Africa (SSA) countries in the middle-income category derive a significant part of their GDP from trade in extractive industries/sectors. These sectors, due to political economy factors, are characterized by high initial inequality (see Alemayehu and Abebe 2006).

Figure 4: Opnnes and Inequality in 1990-2001 (28 African Countries)
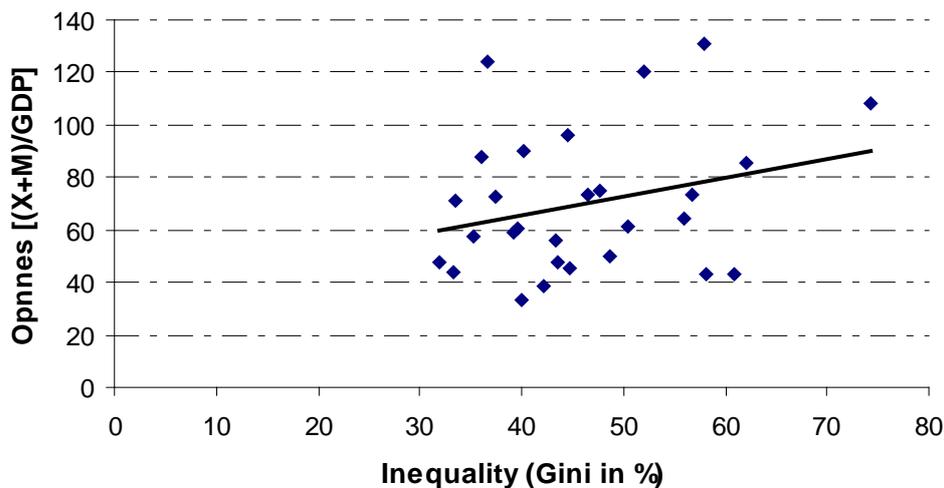
In line with Figure 4 most cross-country regressions have found that openness, defined in different ways, is positively correlated with income inequality (e.g. see Fischer, 2000 and Easterly, 2002)[5]. Apart from the theoretical explanations for this evidence (such as the biased demand for skilled labour when developing countries liberalize their trade), there is also a political economy side to the story. In line with this Easterly (2002) argues that resource rich countries that depend primarily on a few products for their exports tend to have institutions and political frameworks that favour the persistence of income inequality. That is, more open economies in Africa tend to depend on one or two major export items (mineral, oil or primary commodity), and are characterized by high *initial* inequality. Such initial inequality could be sustained by trade liberalization. The impact of initial inequality on efficient growth and poverty reduction needs serious consideration. Figure 5 illustrates how the responsiveness of poverty to growth (elasticity of poverty to growth) varies with initial income inequality in SSA. The figure shows that countries with low levels of income inequality need a much lower rate of per capita income growth than those with high initial income inequality to reduce poverty by half by 2015.

---

[5] Some disagree on the assertion that trade reform worsens income inequality on the grounds that the causation is weak (e.g. Srinivasan and Wallack, 2003). Dollar and Kraay (2001) also takes the view that greater openness is neutral with respect to income distribution.

Figure 5 Initial inequality and overall growth required to halve poverty by 2015 in SSA

Growht Requirement

[Scatter plot with y-axis "Growht Requirement" ranging from 0 to 0.9, and x-axis "Initial Gini Coefficient" ranging from 0 to 80]

Initial Gini Coefficient

From the discussion thus far, it is noted that initial inequality in Africa is strongly correlated with the degree of openness of the economy. That said, these countries need rapid and sustained growth in order to significantly impact poverty. In fact, if countries can contain income inequality to its existing level, modest growth would be sufficient to reduce poverty by half by 2015 (see Alemayehu and Abebe, 2006). The issue therefore is that each country needs to consider how the interaction of trade reform and income inequality affects poverty. The contributions of trade reform to growth however, should not be the only guide to be used to design a poverty reduction policy

In summary, the existing empirical literature on Africa shows that the impact of trade liberalization on household welfare is mixed. In most cases rural households, relative to urban, seem to benefit during the initial stages of reform. On the other hand, liberalization changes the level and composition of investment, and causes large redistributions in income that are politically costly and associated with de-industrialization. Which of these effects dominate in a particular country is largely an empirical question. In countries that are non-oil primary commodity exporters, trade liberalization is associated with poverty and thought to reinforce the poverty trap. In general, UNCTAD (2004) reported that the trade poverty relationship improved between the first half of the 1990s and the second half of the 1990s. Using the IMF index, that categorize countries in open, moderately open and restricted countries, the study noted that the greatest improvement is found in the moderately open countries, followed by the restricted ones (UNCTAD 2004).

3.   Trade, Poverty and Inequality in Ethiopia

3.1   The Ethiopian Literature

There is not much work that attempts to link trade liberalization to poverty in Ethiopia. The exceptions are Alem's (1995) and Edris' (2008) attempt in their MSc thesis and the CGE based analysis of Dejene *et al* (2007). Alem (1995) has attempted to study the impact of macro policies, including trade liberalization, on incentive in the traded sector. He concluded that macro policy, via real exchange rate, does have a strong influence on incentive to raise supply of exports. The latter is captured by the relative price of exports. Alem's (1995) results have some problems. First, his analysis stops when he reached the conclusion that macro policy reform (liberalization) influences incentives. He did not pursue it to the next stage of whether the incentive entails supply response with implications for poverty, which is rather fundamental. Second, the real exchange rate (the

propagation mechanism) is computed using export and domestic prices. The latter, however, are used to compute the relative price of exports, which is the dependent variable. Given the fact that in Ethiopia export price is fundamentally coffee price, the high coefficient obtained may basically be definitional. Along similar lines Asmerom (1999) has also estimated coffee supply response function using a small survey and found that real exchange rate change through liberalization has long run but not short run supply effects. The short-run finding is questionable since his descriptive analysis shows that capacity utilization was important. This, as noted above, can be tackled in times series models (See Alemayehu, 2010a, 2010b).

Alemayehu and Alem (2007) have also attempted to see the impact of liberalization policy on urban poverty and inequality using a micro simulation approach where liberalization is assumed to be mediated through the urban labour market. Using data exploratory analysis as well as earning and occupational choice models, together with counterfactual simulation, their study showed that the absence of change in aggregate measure of poverty and inequality after the liberalization episode hides an enormous change when the analysis is carried across different income categories and sectors. Following liberalization changes in incomes (and hence poverty and inequality indicators) of different categories of urban households move in opposing directions and cancel out each other when an aggregate poverty and inequality indicator is computed. The study has shown that although there seem to be limited change in poverty and inequality at aggregate level, there is significant change within and across categories of households. The distribution of household incomes is found to depend on the structure of returns to labour and on the occupational choice the households made (Alemayehu and Alem, 2007). Perhaps the most important policy lesson from Alemayehu and Alem's (2007) study is the importance of understanding issue of distribution of income in the context of drawing poverty reducing macro policies that includes trade liberalization policies. Policy effectiveness could be achieved if we understand the workings of the labour market and how it affects both level and distribution of income (Alemayehu and Alem, 2007).

Alemayehu (2010b) has also examined the impact of trade linearization on coffee which is one of the most important exports of Ethiopia (contributes 35 to 60% to exports in the last decade). From that analysis it is possible to draw some of the implications for poverty and distribution of income. First, it is found that trade liberalization has led to an increase in the level of export (both in quantity and quality), area under coffee cultivation, private sector participation both in the process and marketing of coffee. But this has not brought competitiveness in the sector. In fact most micro evidences examined in this study (see box 1 below) show that the price elasticity is either small or statistically insignificant. This points to the fact that change in price owing to liberalization by itself may not bring about major change in the coffee sub-sector and need to be accompanied by supply side policies. Third, the volume of coffee export, prices and farm income derived is largely dependent on both national and international trade policies. In this regard the government's domestic (national) policy of coffee market (both domestic and export) deregulation as well as the reduction of coffee taxes are very relevant. However, this does not necessarily imply that the country will benefit from international market. In fact the evidence in Alemayehu's (2010b) study shows that the world coffee market is volatile and with no prospect of rise in prices. The latter has an important implication for food security and poverty reduction. The government cannot rely on the international market to ensure food security and reduce poverty; thus caution needs to be exercised in this regard. Fourth, some of the micro evidences in the study have shown that even if peasants' earnings from export crops increase following liberalization, acquiring the required food depends on the efficiency of inter-regional trade in food (or regional markets). This requires the government or relevant institutions to invest in marketing infrastructure and efficient information system to help ensure nation food security and poverty reduction (See Box 1 below and Alemayehu 2010b)

Box 1: Trade liberalization, Supply Response and Food Security: A micro Evidence Following the Liberalization in 1990s
(Extract from Alemayehu, 2010b)

The extract in this box from three MSc Thesis papers at the Department of Economics of Addis Ababa University offers the glimpse of the impact of trade liberalization on export supply and poverty through food supply at local (county) level. It clearly illustrates the delicate link between trade liberalization and poverty or food security. Coffee being the major contributor to exports of Ethiopia (form 65 to 35% of total exports in the last two decades) and hence a major global linkage for Ethiopia, the box is based on different coffee growing areas of the county. All the studies are made in the late 1990s following the 1992 liberalization and hence giving sufficient time for the effect of liberalization to work.

Taye (1997) made an econometric analysis of coffee supply response to the liberalization or reform carried in Ethiopia in the early 1990s. His analysis is based on a sample of farm households drawn from two districts (Gomma and Manna) of the Jimma region (to South of the Capital). According to his data, following liberalization there is an increase in movement of resources to the coffee sub-sector. This is shown by the fact that area under coffee cultivation in the two districts, number of coffee seedlings, hired labour and frequency of weeding as well as coffee yield has increased (Taye, 1997: 92; See Table 1 below). Given the coefficients of 0.48 for land and 0.22 for labour in his coffee production function estimated using a log-linear Cobb-Dougals production function, this shift in resources has definitely contributed to increase in the supply of coffee. Moreover, given the shortage of the two important factors of production (labour and land) in the study area, this shift must have occurred at the expense of food crops production.

Table 1: Resource Shift Effect in Sample Households of Taye's Study

	Pre-Reform/ Pre-Liberalization	Post-Reform/ Post-Liberalization
Area under Coffee (ha)	0.4867	0.6265
Coffee Seedlings (no.)	201.00	497.61
Hired Labour (MDs)	19.19	30.49
Wedding (frequency)	2.20	3.08
Coffee Yield (kg/ha)	425.35	452.51
Spraying against CBD (kg)	18.10	2.06

Source: Survey Data of Taye (1997).

This finding of Taye has implications for food security and poverty, especially, in the light of his other two findings: (a) land and labour are important resources with positive marginal and average product and (b) that the estimated marginal values of using land (216.96 kg per ha) is nearly equal to the value of food crop (maize) forgone – thus there is allocative efficiency. The implication is that in the context of the existing market structure it is rational for the peasants to substitute coffee for food crops and that is exactly what the peasants are doing. This issue brings us to the important question of whether countries such as Ethiopia which depend on volatile coffee market for their foreign exchange earning can afford to forgo the important issue of 'food sovereignty' and hence possible food poverty relying on the possibility of ensuring food security through higher export earnings – 'trade-based food security'. The evidence in this paper is not encouraging to pursue the latter option.

Another micro-based econometric study is Abdurahman's (1995) work on two districts in Hararghe highlands (another important coffee growing area to the East of the capital). In this area average holding of the peasants is divided in to 53 per cent for maize and sorghum (major food crops in the area) and an average of 30 percent for coffee and *c[k]hat* (exportable). Using a survey data of two districts he found strong short-run (two years) supply price elasticity value of 0.60, which is statistically significant. He convincingly argued that this short-run response is attributed to marketing efficiency following liberalization, reallocation of labour to the cash crop sector and a shift of supply from smuggling to the formal channels. The finding about the latter is also in line with the study of Dercon and Lulseged (1994) about coffee smuggling although Dercon and Lulseged argued

that the effect of the parallel market is not as large as sometimes thought (Dercon and Lulseged, 1994: 71). Dercon and Lulseged (1994) noted that following devaluation there is a trend of an increase in coffee production although the increase is unlikely to be large. The latter is partly attributed to the relative price of other competing export crops such as *c[k]hat.*

Another interesting study in the same area (Jimma) is that of Yoseph. The study by Yoseph (1994) is based on survey conducted in Gomma district in Jimma region (South Ethiopia) also confirms the importance of land and labour as crucial inputs in coffee production. Yoseph's study shows that the supply price elasticity is not really important (in the range of 0.14 using a log-log model and statistically significant only at 13%). Rather an interesting finding of Yoseph is that in the sample area coffee producers spend 91.3% of their earning from coffee on food crops. Moreover, in the period from 1992/3 to 1993/4 the price of food crops (maize and sorghum) changed by 11% while coffee price has changed by 61%. This certainly entails a huge incentive to shift to coffee production if only to spend the bulk of this earning on food crops. Here, although food security (and hence poverty reduction) may be attained at the household level indirectly, it could be at the expense of 'food sovereignty' and that possibility is unreliable owing to volatile world coffee market and poor regional food market.

Abdurahman (1995) also found that land and labour are the most important constrains of production activity in the region. The implication of the positive supply price elasticity, acute shortage of land and labour and the food problem in the area is an excellent demonstration of the limitation of using export earning to ensure food security and poverty reduction at micro level. The study area is a food shortage/insecure area. Traditionally farmers engaged in cash crop production such as coffee and *C[k]hat* used to buy cereals/grain from other areas. The study by Abdurahman (1995) shows that peasants in the study area are seriously food insecure and are dependent on precarious regional food markets/flows. Thus, even if one has the capacity to buy food crops from the earnings obtained by selling the exportable coffee, food security for that group of farmers is dependent on the sustained existence of the regional food market/food flow. Abdurahman (1995) also noted that, after liberalization the terms of trade have moved against the agricultural sector in general and the food production in particular. This has created a disincentive effect on the food production and hence on food security and poverty(Abdurahman, 1995: 57-58).

Coming to the two recent studies, Edris's work, using decomposition analysis, has exclusively focused on determinants of inequality including the impact of trade liberalization. Edris (2008) decomposition analysis shows that, in his model, per-capita land holding, household size and location are the major contributors to the overall inequality. According to Edris's result when more cultivable land area is allotted to the production and cultivation of cash crops (coffee, chat etc) exportable susceptible to the effect of liberalization, the per-capita consumption expenditure will be improved with significant coefficient. Belay et al (2007) has used a CGE based simulation exercise about the impact of trade liberalization on poverty and inequality. They found that full liberalization (assumed as tariff removal) may lead to dampening domestic production of manufactured goods while raising the level of exports. The simulation also suggests that the welfare of farm household will improve while that of wage earners will decline and that of entrepreneurs (self-employed) remaining unchanged. However, the overall poverty will increase at national level. (Belay et al, 2007).

Having these recent studies about trade liberalization and poverty (and inequality) in Ethiopia since the onset of liberalization in the early 1990s, it is instructive to see the recent evidence on the issue. This is done in the next subsection.

3.2   Trade Liberalization and Poverty: The current Evidence

The recent evidence about the relationship between trade liberalization and poverty could be inferred from Table 2 below. Table 2 shows the level poverty for representative tradable (Coffee and *Chat*) and non-tradable commodities: *Teff* (staple cereal in Ethiopia) and *Enset* (false banana which is

staple in the Southern part of the country). With coffee and *Chat* accounting for about 60% of exports and cereals (of which *teff* is significant) constituting about 80 % of cereals, these are good proxies for tradable and non-tradable, respectively. The effort in the data on Table 2 is to see the evolution of poverty both in the tradable (which are likely to be affected by trade liberalization directly) and the non-tradable sectors following the progressive liberalization of the Ethiopian economy since 1992. In the table column two refers a dummy variable if a particular commodity (in column one, say coffee) is harvested or not by the household in question. If a farmer doesn't harvest, say coffee, then he is harvesting other crops.

Table 2:   Head count poverty: Tradable & non-tradable sector, 1994-2005

		obs	1994	1995	1997	2000	2004	Average
				Tradable Sector				1994-2004
Coffee	Not harvest	1039	0.58	0.46	0.39	0.47	0.38	0.46
	Harvest	173	0.49	0.70	0.44	0.82	0.60	0.61
Chat	Not harvest	1117	0.60	0.50	0.49	0.50	0.40	0.50
	Harvest	95	0.24	0.34	0.23	0.68	0.47	0.39
				Non-tradable Sector				
Teff	Not harvest	735	0.53	0.51	0.34	0.53	0.42	0.47
	Harvest	477	0.62	0.45	0.47	0.50	0.40	0.49
Enset	Not harvest	858	0.54	0.41	0.35	0.38	0.38	0.41
	Harvest	354	0.64	0.69	0.50	0.85	0.49	0.63

Source: Based on the Department of Economics, AAU, Panel Rural Household Survey

As can be read from Table 2, just following liberalization (except in 1994) the level of poverty on the average is highest in the tradable sector in the entire period. In fact after a decade of liberalization the level of poverty is still highest for those in the tradable sector (see rows which says 'harvest') although the situation in the *Enset* producing areas is similar to the tradable sector. However, the *Enset* consumption is relatively small compared to cereals which constitute more than 80 % total agricultural production (this is represented by *Teff* in Table 2). This evidence is further corroborated by the fact that when coffee producers are not harvesting coffee (hence they harvest other crops which invariably are non-tradable) their level of poverty relatively declines (for coffee throughout and for Chat only after a decade of liberalization, last two columns of Table 2, though).For non-tradable producers, when they are not harvesting this crops their level poverty generally declines but the decline is not that significant for *Teff* while it is for *Enset* producers.

It is also interesting to see from Table 2 that the level poverty is relatively more variable (unstable) in the tradable than the non-tradable sectors. This is not surprising given the fact that those in the tradable sector, such as coffee are usually the victims of the volatility of international prices and terms of trade deterioration. From these evidence it is easy to infer that trade liberalization pursued in the early 1990 have increase poverty and the vulnerability to poverty in tradable sectors of

Ethiopia which are more susceptible to the impact of trade liberalization, compared to the non-tradable ones, assuming a decade is enough to show the effect of liberalization.

We have further examined this issue using a regression approach. The result of this exercise is given in Table 3. After a decade of liberalization, the effect of trade liberalization is expected to show itself in the long-term level of income of the household. Thus, in Table 3 we have attempted to see the major determinants of permanent income that includes engaging in the tradable (or non-tradable) sectors. Our conjecture here that, if engaging in the tradable sector has positive and meaningful impact on long-term income, this has partly because of trade liberalization because trade liberalization has been carried out vigorously during the period under analysis (1994-2005).

Table 3: Determinants of 'Permanent Income' in Rural Ethiopia in Tradable & Non-tradable Sectors

Dependent variable: logarithm of real income	Coefficients	t-statistics
Household size	-0.096	(-16.57)**
Farming systems	0.411	(8.21)**
Female headed households (female reference group)	-0.05	-1.27
Primary school completion of the household head	0.098	1.76
Primary school completion of wife	-0.013	-0.12
Total land of the household	0.075	(2.92)**
Age of the household head	0.001	-1.16
Total current value of household assets	0	(4.83)**
Crop sales either previous meher and belg (r1 & r4) or after last interview	0	(3.75)**
Population of nearest town divided by the distance in km from the site	0	(2.89)**
Dependency ratio	-0.117	(-1.28)
Worked on someone elses land or other employment?	-0.103	(-3.21)**
Dummy for households which harvested teff during last season	-0.011	-0.28
Dummy for households which harvested coffees last season	0.124	(2.24)*
Dummy for household which harvested chat last season	0.238	(4.93)**
Number oxen owned (bulls, oxen and young bulls)	0.019	1.71
Access to credit	0.112	(3.68)**
Constant	3.605	(24.83)**
Observations	1159	
R-squared	0.37	

Notes: ** significant at 5%; ** significant at 1%.*

Table 3 also shows that permanent income is positively related to engagement in the traded sector (coffee and Chat, here). Engagement in the non-traded sector on the other hand a statistically insignificant relationship with permanent income. What we infer from this result is that the traded sector has the potential to raise permanent income and hence reduce the vulnerability to poverty (see also Abebe2006), yet the level of poverty in the tradable sector is relatively high as can be read from Table 2. This apparent contradiction can be unravelled if we ask whether trade liberalization affects the tradable sector (say coffee price and output) positively or negatively. If trade liberalization affects the sector positively (say through rising prices and incentive to raise output) it will reduce poverty by raising permanent income. If it on the other hand affects it negatively or expose it to vulnerability, it will have a negative impact on poverty. The micro evidence in Ethiopia seems to suggest to the latter (see box 1 and Table 2 above). This result need to be also examined in the light of the evolution of inequality following liberalization. This important because the evidence

in Ethiopian shows that inequality is strongly and positively associated with poverty (see Alemayehu et al 2008). The evolution of world price for Ethiopia's exports does also matters.

The result reported in Table 3 is also interesting in many other ways. Long term income of a typical rural household is negatively correlated with size of the household, the head of the household, that is, whether female or male. On the other hand, such factors as initial wealth, assets, experience and access to credit have a positive effect on 'permanent' income. This is a further evidence of the positive role that initial endowment, including access to credit, has on household welfare. The importance of the distribution of initial endowment difference (a proxy for inequality, see below) for income should be obvious, especially if that initial difference persists or worsen following liberalization (see below). In addition, access to finance, which itself is related to initial endowment, in reducing poverty is especially important since income variability is a major factor in inflicting poverty in Ethiopia. The latter can be inferred from the fact that the transitory component of poverty comprises about 15 to 20 percentage points of the total poverty. In sum, the growth-inequality nexus is important to understand the impact of trade (trade liberalization) on poverty. This is because invariably trade liberalization is associated with inequality in Africa (see Abebe and Alemayehu 2006) and that inequality and poverty are positively and strongly associated with poverty in Ethiopia (Alemayehu et al 2008).

In the Ethiopian literature, Employing Computable General Equilibrium (CGE) micro-simulation analysis, Dejene et al (2007) investigate how unilateral trade liberalization impacts poverty and income distribution on the Ethiopian households based 2001/02 SAM constructed by IFPRI and on the Ethiopian Household Income and Consumption Expenditure survey of 1999/2000. According to this study, the welfare impact of full liberalization on entrepreneurs including informal operators is found to be insignificant, but it affects the wage earner adversely. Concerning inequality, the study found that trade liberalization may not have a significant impact on income distribution which indicates that the study doesn't come up with a conclusive result about the impact of unilateral trade liberalization on income distribution in Ethiopia.

However, Dercon (2007) investigated same issue by highlighting the impact of a first wave of liberalization in the early 1990s, using the evidence from a rural panel dataset. It was found that while liberalization had some positive effects in this particular period, the benefits were largely confined to households with good assets, not least in terms of geography and road infrastructure. Analysis of the subsequent years shows that access to infrastructure seems to have been causing even further growth and poverty divergence within rural Ethiopia. This evidence suggests that access to better infrastructure and communications is crucial to allow households to benefit from further liberalization and engagement in the world economy. Finally, some evidence is presented by Dercon (2007) showing that liberalization has shifted the nature of risks faced by households towards a higher incidence of market related risks, such as sudden output price collapses or input price increases. This is in line with the vulnerability issue noted above (see Table 2). Similarly, as we noted above, Edris's (2008) study found that none of the most important determinants of inequality in his model that focused on the tradable sectors are found to be equalizing, meaning that each of the variables exacerbates income inequality. Of these determinants, per-capita land holding, household size and location are the major contributor to the overall inequality

Using the same household panel data, Alemayehu et al (2008) found that income inequality and economic growth are highly correlated and pro-poor growth strategies compared to the status quo or worsening inequality would bring a dramatic change in the level of poverty. According to this

study, from a baseline in 2000 of a 30 percent poverty share, over ten years at growth of 4 percent per capita, poverty would decline from 44 to 26 percent for distribution neutral growth (i.e., no change in the aggregate income distribution). In contrast, had the growth increment been distributed equally across percentiles (Equally distributed gains of growth, EDG), the poverty would decline by over half, to 15 percent, a difference of almost 11 percentage points. Thus, 'distribution matters', even, or especially in a poor country like Ethiopia. Thus, if trade liberalization since the 1992 is accompanied by inequality, it must partly be responsible for the limited success in reducing poverty. Thus, the question is whether the liberalization is associated with growth and inequality. The evidence is given in Tables 4 and 5.

First, trade liberalization since the 1992 is positively associated with growth as can be read from Table 1. This is encouraging. Unfortunately this growth is associated with rising inequality, especially in urban areas although the level is not significant using both national and panel data as can be read from Table 1. To the extent that trade liberalization leads to growth with inequality, its effect on poverty depends on the impact of inequality on poverty. This is given in Table 4. As can be inferred from Table 4, inequality is as important as growth in determining the level of poverty in Ethiopia. In fact Alemayehu *et al* (2003) estimated the poverty (headcount) elasticity with respect to growth and inequality to be -2.32 and 1.19, respectively.

Table 4: Growth and Re-distribution Components of the Change in Poverty: 199-2004

	Total Change in Headcount Ration	Change due to economic growth	Change due to re-distribution
Rural	-15.296	-8.223	-7.073
Urban	4.016	-1.671	5.687

It is difficult to conclusively attribute the evolving inequality shown both in Table 1 and Table 2 to liberalization in general and trade liberalization in particular. However, the existing evidence in Ethiopia as well as other African countries reviewed in this study shows that micro model based simulation shows that liberalization is associated with inequality (see Alemayehu and Alem, 2006; Alemayehu and Abebe 2006). Secondly, the determinants of inequality in Ethiopia are found to be endowment differences (see Table 5). Such endowment differences are invariably worsened or at best sustained by trade liberalization in many African countries (see Abebe and Alemayehu, 2006). Given these evidence it is plausible to infer that part of the reason for increased headcount poverty indicators for the tradable (as well as the non-tradable sectors) given in Table 2 could well be due to inequality which itself is positively related with (trade) liberalization.

Table 5: Determinants of Gini coefficient in rural Ethiopia-Random-effects model: 1994-2004

	Coefficient	t-values
Average land size holding at village level	-0.054	(-14.42)**
Standard deviation of land size at village level	0.010	(11.75)**
Percentage of household head with primary education at village level	0.625	(6.65)**
Percentage of wives that completed primary education at village level	0.500	(4.19)**
Hausman specification test between random and fixed effects model (p-value)	0.320	
Number of observations	75	

* significant at 5%; ** significant at 1%, 14 village dummies are included in the regression to control for other village characteristics.

4.   Conclusion and Policy Implications

Trade liberalization policies were critical instruments deployed in African countries during the SAP era, and trade remains the most significant channel through which global interdependence impacts the welfare level of ordinary African citizens. Justifiably, there is a need for in-depth analysis of the patterns and implications of trade liberalization polices on growth, inequality and poverty. The global market remains extremely important to Ethiopia, especially given its dependence on trade in a few commodities such as coffee, the dominant effect of trade in the economy, and the secular deterioration and volatility of its terms of trade.

This engagement of Ethiopian in the world economy is not a smooth one, as illustrated by the outcome of liberalization policies and the enormous distributional consequences in the short to medium run. The impact of trade liberalization on household welfare varies considerably from country to country, and depending on the circumstances, it could improve social development or exacerbate existing poverty and inequality. Destitution and inequality are more likely to worsen in the presence of weak domestic industries and institutions, low degrees of inter-sectoral labour mobility, weak financial institutions, frequent policy reversals, and challenging market structure of the tradable and non-tradable sectors (see Alemayehu 2002). In Ethiopian case in particular we found the majority of the afro mentioned characteristic to prevail. It seems it is for this reason that trade liberalization is somehow positively associated with poverty in the tradable sector of Ethiopia.

We also found that trade liberalization is associated with inequality, especially in urban Ethiopia. Existing income inequality is relatively high in most African countries, which makes the distributional consequence of trade policies a serious matter. Cross-country evidence shows the positive correlation between trade policies and income inequality through the channel of land abundance (e.g. Fischer, 2000), and through political economy factors for Africa (e.g. Easterly, 2002). In some cases, trade liberalization could also worsen income distribution by reducing the demand for unskilled labour. A related issue is the impact of trade reform on intra-household inequality and gender disparity. Even if the aggregate welfare of a household increases, it is possible for some measures of trade reform to increase intra-household inequality through changes in employment opportunities between male and female household members (Winters, 2002) as well as through changes in the composition of the whole workforce (UNDP, 2003). Sectors such as textiles may rapidly expand in the wake of trade liberalization, which in Africa, are mostly female-intensive (Blackden, 2003). Depending on the relative wages in these sectors, overall inequality tends to rise

even if more women are employed in the economy. We also found in Ethiopia that different sectors, regions (rural vs urban) and income groups to be affected differently by liberalization. Given the strong detrimental impact of inequality on poverty in Ethiopia noted in this study, the liberalization impact on poverty is not positive either. Thus, the design and implementation of trade policies in Ethiopia requires taking all of these issues into consideration.

There are also positive effects of liberalization if the global market is conducive, as we have shown in this study in raising permanent income. The positive effects of trade liberalization can be enhanced if policymakers act at the right time, and institute basic macroeconomic stability policies (e.g. Bhagwati and Srinivasan, 2002; Winters, 2002). For instance, inflationary trade policy measures can be controlled with appropriate macro-stabilization policies. These stabilization policies though, in most cases hurt the poor. Thus, it is important to decide the appropriate timing of the trade reform in order to maximize gains and minimize the adverse effects on the least well-off. Despite this, the problem related to trade liberalization could remain forever as long as countries such as Ethiopia are structurally dependent on export of few primary commodities such as coffee with a history of volatile price and terms of trade deterioration.

The question then seems to be why Ethiopia has not diversified its exports to manufactures, services or processed raw materials, all of which offer better growth prospects and poverty reduction. One reason may be that such a switch requires capital (infrastructure and plant) and skills (or 'human capital') that country does not currently possess (see also Alemayehu 2002).

The question then, is how? Improved access to developed country markets for processed primary commodities, and, in particular, access to the European and American market (along Everything but Arms of EU and The African Growth and Opportunity Act of the US) would be a first and important step. Commodity price stabilization schemes are currently out of favour and would require the full co-operation of the major importing transnational corporations in order to work at all. However, this is a problem of price volatility around the trend, as well as the declining trend itself. Reducing this volatility would benefit both importers and exporters and thus should not be impossible to achieve through a properly administered buffer stock system. The market mechanism alone cannot produce this result since hedging ranges are so short, so this would have to be a form of public intervention. However, the long-term downward direction of the terms of trade is difficult. It would not matter so much if volume was increasing fast enough to raise the income terms of trade (as is happening with labour-intensive manufactures), but this is not, in fact, the case. The market for tropical commodities is oligopolistic and riddled with restrictive practices, e.g., sugar and cotton in the US and bananas and coffee in Europe. Therefore, a producer's cartel may be the only theoretically viable solution. However, in spite of the recent success of OPEC in driving up oil prices, let alone Ethiopia Africa is unlikely to be able to organize such a cartel given the worldwide competition in those commodities. Ethiopia needs to push such policy through continental and international platform, however.

Within its policy space, Ethiopia needs to change the mix (or at the very least upgrade the quality) of its primary export products in order to compete within the foreseeable future. This requires investment, in particular using joint ventures with foreign companies, by domestic investors, such as firms and households, as well as by reversing flight capital. More than savings, risk is the main problem, since there is plenty of capital held overseas and also plenty of liquidity within the banking system. That way, the vulnerability for the effect of global economy such as trade could be reduced. In addition, integrating poverty diagnostics with trade policies can minimize the negative effects of trade policies. Poverty mapping assists in development of trade reforms that benefit the poor or minimize their welfare loss. Poverty decomposition along sectoral lines and income groups also provides analytical tools to evaluate who benefits from trade liberalization, thus helping

policymakers devise the most appropriate and effective intervention strategies on behalf of the poor (Kanbur, 2000).

Finally, ownership of policies, such as trade liberalization and PRSPs, is crucial. In order to realize the objective of poverty reduction, strategies must be designed in a way that ensures the sustainability of recent gains in the macroeconomic sphere and their integration with social objectives. This will take the form of pro-poor growth and relevant macro policies. The government's record in these areas is encouraging (except in the last three years), although reform in some areas has still lagged behind. The post-*Derg* period witnessed a major policy shift from its immediate predecessor. It started liberalization of the economy, including trade liberalization, in a typical Structural Adjustment Programme (SAPs) fashion, though this was to a large extent nationally designed and owned. Partly because of these policies, the growth performance was much better than the previous two regimes. The challenge is to make this growth pro-poor and sustainable. A pro-poor outcome results from a pro-poor *strategy*, which consists of goals, targets, instruments and monitoring. It involves policy that requires government leadership, to establish a set of incentives and interventions that consciously and purposefully alter the outcome of the current growth and distribution process, within an economy in which production and exchange overwhelmingly derive from the private sector. It is only when such a strategy is pursued the country will benefit from the potential positive effects of trade liberalization on growth and poverty reduction and avoid or minimize its adverse impact in increasint poverty and inequality.

Reference

Abdurahman Amme (1995) 'Coffee Supply Response in the Hararghe Highlands' (MSc Thesis, Department of Economics, Addis Ababa University).

Alem Aberaha (1995) 'The Impact of Macroeconomic Policies on Incentives to Agriculture', **Ethiopian Journal of Development Research**, 17(2): 39-78.

Alemayehu Geda (2008) 'The Political Economy of Growth in Ethiopia' in by Beno Ndulu, Stephen O'Connell, Robert Bates, Paul Collier and Charles Soludo (eds.) **The Political Economy of Economic Growth in Africa, 1960-200.** Cambridge:, Cambridge University Press.

Alemayehu Geda (2009) ' The Implications of the Global Financial and Economic Crisis on Africa: Simulation Results from African Global Macroeconometric Model' (Mimeo , Department of Economics, Addis Ababa University and also at www.Alemayehu.com)

Alemayehu Geda (2010a) 'Macroeconomic Policy and Agriculture in Ethiopia' in Alemayehu Geda. **Readings on Ethiopian Economy** (forthcoming Addis Ababa University Press).

Alemayehu Geda (2010b) 'Trade Liberalization and the Coffee Sub-Sector with Some Implication for the Food Sub-sector' in Alemayehu Geda. **Readings on Ethiopian Economy** (forthcoming Addis Ababa University Press).

Alemayehu Geda and Abebe Shimeless (2006) "Openness, Trade Liberalization, Inequality and Poverty in Africa' in K.S. Jomo and J.Baudot (2006). **Flat World Big Gaps: Economic Liberalization, Globalization, Poverty and Inequality.** New York: Zed Books and United Nations.

Alemayehu Geda and Alem Abreha (2007) 'Macro Policy Reform, Labour Market, Poverty & Inequality in Urban Ethiopia: A Micro-simulation Approach', Ethiopian Journal of Economics, Vol 7, No. 2.

Alemayehu Geda, Abebe Shimeless and John Weeks (2003) 'Growth, Poverty and Inequality in Ethiopia' (Bacground Paper for Ministry of Finance and Economic Development, MoFED, Addis Ababa)

Alemayehu Geda, Abebe Shimeless and John Weeks (2008) 'Growth, Poverty and Inequality in Ethiopia: which way for Pro-poor Growth', **Journal of International Development**, Vol 21 (7):947-970, Published online Dec 3, 2008.

Asmeron Kidane (1999) 'Real Exchange Rate Price and Agricultural Supply Response in Ethiopia: The Case of Perennial Crops' (AERC Research Report 99).

Belay Befekadu, Dejene Aredo and Sindu Werknes(2007) 'Trade Liberalization, Poverty and Inequality in Ethiopia: A CGE Microsimulation Approach (Paper presented at the 6th Poverty and Economic Policy Research Network Work shop, Limma, Peru, Junr 14-16, 2007)

Ben-David, Dan Håkan Nordström and Alan Winters (1999) 'Trade, Income Disparity and Poverty' WTO Special Studies, Geneva,:WTO Publicaion.

Buffie, E. (1992). Commercial policy, growth and distribution of income in a dynamic trade model. *Journal of Development Economics* 37: 1–30.

Collier, Paul, and Jan W. Gunning (1996). Trade liberalization and the composition of investment: Theory and African application. Processed, Centre for African Economic Studies, University of Oxford, Oxford.

Dejene Aredo., Belay F. and Sindu W. (2007): "Trade Liberalization, Poverty and Income Inequality in Ethiopia: A CGE Micro simulation Analysis," *6th PEP Research Network General Meeting, Sheraton Lima Hotel, Paseo de la Republica 170*.

Dercon, S. (2007): "Globalization and Marginalization in Africa: Poverty, Risk and Vulnerability in Rural Ethiopia," *UNU/WIDER,* Research Paper 2007/73.

Dollar, David (1992). "Outward-Oriented Developing Economies Really Do Grow More Rapidly: Evidence from 95 LDCs, 1976-85." *Economic Development and Cultural Change* 40 (3): 523–544.

Dollar, David, and Aart Kraay (2001). Trade, growth, and poverty. Policy Research Department Working Paper No. 2615, World Bank, Washington, DC.

Easterly, William (2002). Inequality does cause underdevelopment: New evidence from commodity endowments, middle class share, and other determinants of per capita income. Working Paper No 1, Centre for Global Development, Washington, DC.

Edris Hussiel (2008) 'Trade Liberalization and Income Inequality in Rural Ethiopia' (MSc Thesis, Department of Economics, Addis Ababa University).

Rodrik, Dani (1998). "Trade Policy and Economic Performance in Sub-Saharan Africa." NBER Working Paper No. 6562, National Bureau of Economic Research, Cambridge, MA.

Taye Yadeta (1997) 'Measuring and Assessing Distortions in coffee Commodity System: The Case of Jimma, Ethiopia' (MSc Thesis, Department of Economics, Addis Ababa University).

Winters, Alan, (2000). Trade, trade-policy and poverty: What are the links? Discussion Paper no. 2382, Centre for Economic Policy Research, London.

Winters, Alan, Neil McCulloch and Andrew McKay (2002). Trade liberalization and poverty: The empirical evidence. Discussion Paper in Economics No. 88, October, University of Sussex, Brighton.

Winters, Alan, Neil McCulloch, Andrew McKay (2004). "Trade Liberalization and Poverty: The Evidence So Far." *Journal of Economic Literature* 42: 72–115

Yoseph Abdisa (1994) 'Coffee Supply Response: Implications for Structural Adjustment Program in Ethiopia' (MSc Thesis, Department of Economics, Addis Ababa University).

LIST OF IAES WORKING PAPERS

No	Authors	Title	No and Year
		2011	
1	**Alemayehu Geda and Kibrom Tafere**	**The Galloping Inflation in Ethiopia: A Cautionary Tale for Aspiring 'Developmental States' in Africa**	**WP A01_2011**
2	**Alemayehu Geda, Kibrom Tafere and Melekt Amedu**	**Remittance and Remittance Service Providers in Ethiopia**	**WP A02_2011**
3	**Alemayehu Geda and Abrham Abebe**	**A Dynamic Modelling of Gebre-Hiwot Ideas: 0f Early 20th Century Ethiopia's Development Problems**	**WP A03_2011**
4	**Alemayehu Geda and Atenafu G. Meskel**	**Impact of China-Africa Investment Relations: Case Study of Ethiopia**	**WP A04_2011**
5	**Alemayehu Geda**	**Economic Ideas of Gebre-Hiwot Baykadagn (A great early 20th[1924] century thinkers, in AMHARIC)**	**WP A05_2011**
6	**Alemayehu Geda and Idris Hussein**	**The Potential for Intra-Africa Trade and The Supply and Demand Constraints for its Realization**	**WP A06_2011**
7	**Alemayehu Geda and Kibrom Tafere**	**Official Development Assistance (Aid) and Its Effectiveness in Ethiopia**	**WP A07_2011**
8	**Alemayehu Geda and Abebe Shimelesss**	**Trade Liberalization, Inequality and Poverty in Ethiopia**	**WP A08_2011**