TRANSITIONAL PERIOD ECONOMIC REFORM PROGRAMME IN ETHIOPIA: 1991-93

1 BACKGROUND

Ethiopia, situated in the north-eastern corner of Africa known as the Horn, neighbours Djibouti, Somalia, the Sudan, Kenya and Eritrea. It has a total land area of 1.224 million sq km comprising a central highland mass surrounded by lowlands. The tenth largest country in Africa, Ethiopia, is endowed with major water resource potential for irrigation and hydroelectric generation. It can produce 60 billion kwh. of electricity from its water resources of which only 1.2 billion kwh. are being exploited. It also possesses vast geothermal energy potential. 840,700 sq km of agricultural land are coupled with 88,200 sq km of forest land. Ethiopia's 1992 population is estimated at 53 million (the second highest in SSA) with an annual growth rate of 3 per cent, an infant mortality rate of 110 per 1,000, and life expectancy at birth of 47 years. Primary school enrolment of the school age population remains below the average for low income African countries. All its social indicators are broadly consistent with its per capita income of $120, among the lowest ten in the world.

The Transitional Government of Ethiopia (TGE) was set up in July 1991 following the collapse of the dictatorial military regime that had evolved after the 1974 Revolution. A 'National Conference on Peace and Democracy' held in Addis Ababa, Ethiopia in July, 1991, adopted the 'Transitional Period Charter of Ethiopia' which stipulates the right to form political parties; an independent judiciary; rights of nationalities to administer their own affairs within their own territory. The TGE will hold power until national elections are called under a new constitution. The TGE has begun the process of establishing a democratic and decentralized political system. Local and regional elections took place in June 1992.

2 ETHIOPIA'S ECONOMY PRIOR TO THE 1991-93 ECONOMIC REFORM PROGRAMME (ERP)

GDP growth has been persistently declining since 1988 and has rarely exceeded population growth over the past 40 years.

Ethiopia has a predominantly agricultural based economy, 40 per cent of GDP, 85 per cent of exports, 85 per cent of total employment. About 15 per cent of Ethiopia's agricultural land is under cultivation in a sector characterized by peasant farming. Field crops account for about 40 per cent of the gross value of agricultural production, livestock another 40 per cent, export and industrial crops 20 per cent. The industrial sector contributes some 12 per cent of GDP and 15 per cent of export earnings. It produces mainly agro-processed goods, textiles and garments, and leather products. It is dominated by public enterprises, which contribute more than 70 per cent of manufacturing value added; the rest is accounted for by small private enterprises. The rest of the national output is attributable to the service sector whose contribution has been driven by high government expenditure.

Coffee accounted for 60 per cent of export value in 1990. Other exports include leather and leather products, oilseeds, pulses, live animals, sugar, fruits and vegetables, and spices. The Ethiopian economy is characterized by low productivity, structural rigidities, and a large public sector. Infrastructure is poorly developed and inefficient with one of the lowest road densities in Africa. Nearly three-fourths of Ethiopia's farms are not easily accessed from all weather roads.

Performance of the Ethiopian economy has been very poor during the 1974 to 1991 period. By 1989/90 overall GDP growth was minus 0.9 per cent below zero, and in 1990/91 it declined, by a further 0.3 per cent. Major contributors to the declining performance of the Ethiopian economy included the restrictive economic policies after the Revolution of 1974, severe weather fluctuations, natural calamities and drought; and the diversion of resources from productive use to finance the military and the civil war, which by 1990 absorbed more than 50 per cent of the recurrent budget; external shocks resulting from unfavourable terms of trade, and the external debt burden.

Ethiopia's people faced a chronic food deficit (due to low food production) which was only made good through external food aid. Agriculture apart from being unable to supply agricultural raw materials required by the manufacturing sector, failed to generate sufficient foreign exchange earnings for the procurement of operating inputs and spare parts, thereby affecting the productive capacity of all sectors.

3 BALANCE OF PAYMENTS

Declining export earnings and rising merchandise imports, despite positive non-factor service receipts, resulted in Ethiopia's current account deficit rising during the 1980s. Export earnings declined from Birr 942 million in 1985/86 (about $450 million) to Birr 756 million in 1989/90 and further to Birr 389 million in 1991/92; while imports increased from Birr 2,018 million in 1984/85 to Birr 2,274 million in 1989/88. Consequently, the visible trade deficit jumped from Birr 1,274 million to Birr 1,486 million in 1987/88 and further to Birr 1,777 million in 1991/92. The decline in the price of coffee, which accounts for 60 per cent of the total export value parallel to a fall in volume of coffee export was the major cause. Other export items also experienced a fall in the volume of their export. All exportables have been subjected to illicit trade across borders with smuggled exports are estimated to have amounted to 30 per cent of the official.

For the same period the country witnessed a tremendous increase in imports to finance the import of food, raw materials, fuel and capital goods. The trade deficit was 10 per cent of GDP in 1988/89 and 9.3 per cent in 1989/90. The widening resource gap led to increasing dependence on external financing. The current account deficit has been financed essentially through public transfers including grants and external borrowing from multilateral and bilateral sources. There was a substantial inflow of grants for famine relief after the 1985 drought. Developmental grants and credits from some socialist countries were obtained in the 1980s. Foreign exchange reserves, boosted by the large receipts of relief assistance after the 1985 drought, were massively depleted in the ensuing years to 3 weeks merchandise imports at the end of 1989. In 1990/91 reserves went negative.

State external borrowing to finance the current account deficit led to indebtedness (excluding military aid), rising 1,488 million Birr in 1980, increasing to 3,336 million Birr in 1984/85 and 7,252 million Birr in 1989/90. The ratio of foreign debt to GDP jumped from 18 per cent in 1980 to 34 per cent in 1984/85, and 58 per cent in 1989/90.

Debt servicing, as a share of exports earning rose sharply from about 8 per cent in 1980 to 25 per cent in 1984/85, and a phenomenal 61 per cent in 1989/90. It further rose, on a commitment basis, to 81 per cent in 1991/92. Unable to meet its loan obligations, Ethiopia went into arrears for the first time in 1989/90 to the tune of 358 million Birr. In 1990/91, it built up an additional 456 million Birr arrears. As of October 1992, the total payment arrears amounted to about 1,000 million Birr, significantly greater than one year's exports earnings. Barring substantial cancellation, debt repayment has rendered the balance of payments position unsustainable.

4 GOVERNMENT REVENUE AND EXPENDITURE, MONEY SUPPLY, BANKING

During the 17 years ending 1990/91, the overall budget deficit (including grants) showed substantial fluctuations and averaged 7 per cent of GDP. Revenue rose to about 13 per cent of GDP in 1974/75 because of tax and discretionary revenue measures such as the war levy and mandatory contributions from public enterprise surpluses, reaching a peak of over 31 per cent in 1988/89. Total expenditure rose from about 17 per cent of GDP in 1974/75 to almost 47 per cent in 1988/89 The rise in total expenditure during the period was largely due to climbing military expenditures and relatively high capital outlays. After reaching more than 16 per cent in 1989/90, the budget deficit fell to 13 per cent of GDP in 1990/91 with revenue and expenditure 25 per cent and 38 per cent respectively. A sharp drop in military outlays in May 1991 was largely offset by a fall in revenue, which stemmed from the slow-down in economic activity and from disruption of revenue collection in the final months of the civil war. The overall budgetary deficit has been covered by both domestic bank and pension fund borrowing and external loans and grants. Because the domestic bank financing was not backed by production, it became inflationary.

Bank financing of the budget deficit tremendously increased the volume of money supply. Broad money expansion average about 12 per cent annually during the period of 1973/74 - 1990/91, while the growth of credit to the non-governmental sector sharply declined. In 1990/91 broad money recorded the highest increase in recent years – 18 per cent – fuelled by bank financing of the fiscal deficit. Despite the growing inflationary pressure, the level and structure of nominal interest rates have remained unchanged since 1986 when lending rates were revised downward and were differentiated to favour economic activity in the socialized sector (co-operatives and public enterprises). Time and deposit rates were also revised to encourage long-term deposits by small depositors. Interest rates which had been positive in real terms throughout the 1980s, became generally negative by 1989/90.

The impact of budget deficit financing was a general price rise for basic commodities and services. The Addis Ababa Retail Price Index showed a rise in inflation rate of 5 per cent in 1989/90 to 20 per cent in 1990/91, with no growth in nominal household income for the same period. The inflation gave rise to a stagflationary economic crises with rapidly falling living standards and rampant unemployment.

The Ethiopian Birr remained pegged to the US dollar at the rate of Birr 2.07 per US dollar between 1973 and 1992. Reflecting the movements in the dollar, as well as the relative prices between Ethiopia and its trading partners, the real effective exchange rate of the Birr appreciated substantially from 1973, the scope of the illegal parallel markets widened with Birr US dollar in excess of 6 to 1. Consumer prices of a large proportion of imported goods reflected the parallel rate.

5 INVESTMENT AND SAVINGS

The Gross Fixed Capital Investment ratio declined from 16 per cent of GDP in 1986/87 to 9 per cent in 1991/92. The declining investment ratio coupled with population increase and unemployment brought about the deepening of the economic crises. Savings declined throughout the 1980s to reach 0.2 per cent of the GDP in 1990/91 go negative in 1991/992 year when GDP could not cover total domestic consumption. As a result, gross fixed investment was totally financed by external sources. The resource gap rose to 12.3 per cent of GDP in 1991/92 even though barely over 10 per cent gross and possibly negative at net level.

6 ETHIOPIA'S NEW ECONOMIC POLICY DURING THE TRANSITIONAL PERIOD

As a result of the misguided policies of the previous dictatorial military regime and of the civil war, the Transitional Government of Ethiopia (TGE) inherited a shattered economy. Structural problems, natural and man-made calamities, and civil strife have had a stifling impact on the economic growth. Recurrent droughts have had a devastating effect on the natural and human resources of the countryside. Much of industrial production came to a standstill; essential infrastructure had been destroyed by war damage and neglect, with exports falling to their lowest level in 20 years. an accompanying social crises involved millions of displaced persons, refugees, demobilized soldiers, homeless and unemployed people.

To reverse this declining trend, TGE drew up a new economic policy in 1991 to reorient and revitalize the country's economy. The overall objective was first to encourage growth by replacing the previous centrally planned economy with a market based economy, and second to reduce poverty and create an enabling environment for economic development.

Changing the role of the state in the economy was seen as crucial, because it is evident that in the past state control over the entire economy was a major cause of economic decline. The new role is to include:

a designing economic policies mapping out economic development strategies and promulgating laws and regulations that foster economic development;

b participating directly or through joint venture arrangements in activities that are considered essential and in which the private sector is not willing to participate;

c designing implementing and supervising the expansion of infrastructure, research and development, manpower training as a basis for economic expansion;

d creating enabling conditions to encourage private production and investment expansion and to provide opportunities for popular participation at household, community and co-operative level;

e protecting consumers and producers against price fluctuations and taking regulatory measures to prevent shortages of basic commodities.

One major hindrance to economic development in the past was the restrictive policies imposed on the activities of the private sector. Without changes in the policy, efforts to realize economic recovery were seen to be futile. To encourage private capital participation, the state is to:

a create enabling conditions for the participation of both domestic and foreign private capital in economic activities without any capital limitation;

b remove all existing bureaucratic procedures and red-tape and introduce and operate new laws and regulations to enhance domestic and foreign private capital participation;

c provide incentives and encouragements to promote domestic capital participation, encourage a wider participation of private foreign capital. The state will work out a comprehensive package of incentives for domestic and foreign private capital participation;

d Provide special encouragement free from state interference to communities participating in economic development.

In order to achieve immediate and durable results in economic reconstruction and for sustainable growth, it is seen as essential to enlist popular participation. Hence, appropriate recognition needs to be accorded to the decisive role the public can play in national economic reconstruction and development. The policy of centralization adopted by the previous government prevented the participation of local government organs and the public in formulating and implementing economic policies. Without voluntary popular participation and initiative, it is perceived to be utterly impossible to solve the present economic impasse.

Local administrative organs are to be given the opportunity to play a greater role in the implementation of the economic policy as well as in relief and rehabilitation programmes, consistent with the overall strategy of decentralization of powers to regional and local government. It should be noted that the participation of the public will not, as in the past, be on the basis of compulsion, contrary to their interest or against their beliefs.

Since national and regional administrative organs are the machineries for popular participation through democratic elections, they will have the right over the ownership and management of resources. The state will issue detailed policies defining relationships between national and regional administrative organs and the Central Transitional Government regarding the ownership of resources and on regional economic responsibilities.

In order to achieve the objectives of the Transitional Economic Policy, the Government will have to secure substantial external resources and channel them in a co-ordinated effective manner to economic reconstruction. Securing external support will of necessity be a major foreign policy objective.

Past macroeconomic policies were designed to serve the defunct regime and are inconsistent with the new economic policy. Therefore, they have to be revised, and in some cases new policies have to be issued, in order to ensure consistency with the new economic policy.

a Policies, laws and regulations regarding money supply, credit and interest, taxes and investment consistent with the new economic policy, to facilitate a market economy, encourage private sector participation, and facilitate and encourage existing economic establishments to operate efficiently;

b A new labour law to promote productivity and efficiency while at the same time protecting the rights of workers;

c A population policy to ensure a balance between rates of population and economic growth;

d A technology policy to ensure the technological and productivity development of all sectors as a basis for sustained growth.

In tandem with the general provisions of the new economic policy, TGE issued also specific sectoral policies for the transitional period. These include: agriculture, industry, trade, finance, transport and communications, mining and energy, urban development and construction and social.

TGE identified priority areas which merited immediate government attention as a result of the grave prevailing economic and social conditions:

a rehabilitate regions affected by drought and war;

b restore infrastructure destroyed by war and/or lack of maintenance and upkeep;

c give special attention to neglected areas;

d complete on-going projects and

e undertake limited activities in new infrastructure development.

7 PERFORMANCE DURING THE ECONOMIC REFORM PROGRAMME

Major steps taken by TGE in 1992 represent a substantial portion of the strategic shift envisaged in 1991. The Ethiopian Birr was devalued on 1 October 1992, the exchange rate in terms of US dollars becoming 5 to 1 more than doubling the previous rate. To rationalize and increase the availability of foreign exchange a flexible exchange rate policy has been pursued by the National Bank of Ethiopia since April 1993 by periodic auctioning of foreign exchange to importers. Early indications are that export trade through the official channels has increased significantly. To offset the negative effect of devaluation on the cost of living, the TGE made special salary increments in October 1992 for civil servants, including employees of state-run enterprises, and also adjusted income tax deductions.

Reform measures already taken to liberalize the trade include deregulation of the prices of agricultural products and manufactured goods. Automatic granting of trade licences has been instituted and export taxes eliminated. To encourage their production for export minimum guaranteed prices are set for coffee, sesame seed, and haricot beans.

The TGE promulgated a new investment code in 1992 to create an enabling policy environment encouraging private capital participation. In August 1992 a new law to enhance the efficiency, productivity, competitiveness and profitability of public enterprise was issued. Its aim is to enable the enterprises to enjoy management autonomy and to restructure themselves along productive and cost efficient lines. In September 1992, the TGE issued a new labour code which gives management flexibility to address productivity and profitability decisions, while also seeking to protect legitimate rights of workers against arbitrary or oppressive actions.

8 CONCLUSIONS AND PROPOSALS

The structural rigidities of the Ethiopian economy, constitute the most fundamental cause of macroeconomic imbalances. The most important manifestations of these are: the predominance of subsistence agriculture, a narrow manufacturing production base with backward technology, neglect of the informal sector, drought and environmental degradation, disintegration of markets and fragmentation of the economy, weak institutional capabilities and excessive dependence on external factor inputs. The economy was also constrained by unfavourable external factors. The preconditions for balance of payments support and debt relief from external sources were tight. Internally, the economy suffered from lack of relevant institutions, wrong policies, poor accountability, and mismanagement.

As a result of structural problems and poor management of the economy the following constraints can be identified:

- poor agricultural productivity and food insecurity,
- low capacity utilization and declining productivity in the manufacturing industry,
- low savings and investment ratios,
- inability to earn or save foreign exchange,
- population growth in excess of that of GDP,
- poor economic and social infrastructure,
- long and painful recovery of the economy from war and weather disasters,
- unfavourable external factors.

To correct macroeconomic imbalances and to reduce constraint the following areas require strategic institutions;

a Food self-sufficiency: With policy designed to achieve food self-sufficiency including a balance between food production and the production of primary agricultural exports and/or expanding the production base through the use of appropriate technology for the transformation of agriculture to increase food supply as well as agricultural products for export. A credit policy favouring food production and the manufacture of essential goods is needed to achieve the second objective. In parallel a population policy is needed to reduce the pressure of domestic demand for food.

b Management of debt and debt-servicing requires a strong debt-management system for the scarce foreign exchange inflows to be utilized judiciously. Debt management would involve a continuous assessment of debt repayment capacity. Debt acceptance should be rational, by allocating future loans to productive projects that result in quick and high returns to maintain future borrowing capacity

c The satisfaction of basic needs, other than food, should be addressed systematically. To enhance the production of basic goods and services requires the allocation of an increasing share of foreign exchange for imports of inputs for agriculture and manufacturing sectors to result in the expansion of agricultural and industrial employment to raise entitlements as well as to enhance physical supply for encouragement of domestic output import restriction and allocation of foreign exchange should be in ways which strengthen inter-linkages between agriculture and industry.

d Effective use of domestic savings requires systematic reduction of speculative activities and the shifting of resources to productive engagements. Selective interest rates that encourage productive activities, as well as reducing inflation to allow overall interest rate reduction, may be instrumental for resource mobilization and allocation to production as well as commerce. The mobilization of rural savings requires creating and strengthening rural financial institutions.

e The rehabilitation and utilization of currently idle productive and infrastructural capacity is a pre-condition for faster economic growth. Encouragement of greater productive capacity is needed in parallel. A medium term loan fund is intended to provide entrepreneurs with enhanced term capital access at reasonable interest rates.

f Balance of payment management needs to include strategies to encourage capital inflows, especially through remittances by nationals working abroad. Discouraging capital flight and encouraging remittances turn on adoption of measures and procedures that enhance the promotion, prospects and development of small-scale industries. Improvement in the balance of payments also requires the promotion of exports through appropriate fiscal and monetary policies.

g Measures that reduce government expenditure and increase its revenue are needed to reduce budgetary deficits. By broadening tax base and improving efficiency of tax collection machinery more revenue can be raised. Broadening the tax base requires the provision of a package of incentives for investors and entrepreneurs to reduce present high levels of evasion. On the expenditure side, government should reduce expenses of non-productive activities – particularly the armed forces – to release resources for both social (human) and fixed capital (infrastructural) investment.