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INVESTING IN ETHIOPIA

Exchange Rate Review—September 2010

- **In a very bold and unexpected move, Ethiopia's central bank devalued the Birr by 20 percent on September 1, 2010. The magnitude of the adjustment is a big surprise, not least because most macroeconomic indicators did *not* show a need for a sharp devaluation at this particular time.**

- **Given the apparently little justification for a large devaluation from a short-term macroeconomic perspective, we see more longer-term and structural motives for the authorities' actions. More specifically, we think there is now a conscious effort to experiment with a deliberately undervalued exchange rate (the "China Model" one might call it) and to pursue a more aggressive strategy of import substitution. Both these efforts can be seen as being in line with the main objectives of the authorities' recently released draft Five-Year Growth and Transformation Plan.**

- **The impact of the exchange rate adjustment will be quite adverse for several segments of the business community, but most of the encouraging trends observed with the steady depreciations of the past year—strong export growth, slower import growth, and improving foreign exchange availability—will all be reinforced.**

- **Looking ahead, we think that after a nearly two-year period of rather sharp movements in the rate, economic policymakers will henceforth seek to provide an extended period in which the Birr rate is relatively stable and predictable. Thus, despite the authorities' demonstrated ability to surprise, we would venture to say that the regular monthly depreciations of the past will be discontinued from here on and that the exchange rate will stay within a very narrow range for the coming year.**

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Access Capital Research

Exchange Rate Review—September 2010

In a very bold and unexpected move, Ethiopia's central bank devalued the Birr by 20 percent on September 1, 2010. This action moved the exchange rate from Birr 13.6284 to 16.3514 per USD, an increase of Birr 2.72 per USD. The magnitude of the devaluation was similar for other major currencies: the Birr rate to the Euro rose from 17.3 to 20.8, the Birr rate to the Pound rose to 21.2 to 25.2, and the Birr rate to the Yen rose from 0.16 to 0.19—all increases of 20 percent.

The exchange rate adjustment was not totally unexpected, but its magnitude is a big surprise.[1] Indeed, assessments of the appropriate value of the Ethiopian Birr would have given little clues that such a large adjustment was imminent. The process of determining the 'appropriate' level of an exchange rate is of course a tricky exercise in economics and one that may be guided by several alternative macroeconomic considerations. Any one of these macroeconomic considerations by itself should not be seen as a definitive guide but, taken together, they can point to a given exchange rate level being too low or too high. In the case of the Birr exchange rate, virtually all indicators did ***not*** show a need for a sharp devaluation according to our reading of the data.

- **Parallel market premium**: Perhaps the clearest and most readily observable indication of the 'true' value of an exchange rate is its going rate in the parallel market, especially in a setting such as Ethiopia where banks do not have full flexibility to move their rates. On this basis, the parallel market rate just prior to the devaluation (i.e. on August 31, 2010) was only Birr 14.2 per USD. With the official rate at Birr 13.63, this showed a difference of about 4 percent, which might have been taken as the scale of the adjustment needed in the official exchange rate.

- **Trade and Balance of Payments performance**: Export, import, and balance of payments developments in the just completed fiscal year (ending June 2010) were all broadly favorable and showed no urgent need for a major exchange rate realignment. As noted in our 2010 Macroeconomic Handbook, the 30 percent adjustment undertaken in 2009-10 had very much 'done its job': exports jumped to much better than expected $2 billion (a 38 percent rise from the year before), and imports are estimated to have shown modest growth (only 13 percent according to the IMF, and thus well below nominal GDP growth). As always, Ethiopia still had a large trade gap last year but this was more than covered by other foreign exchange inflows such as remittances, grants, foreign investment, and loans. The overall balance of payments, which is what actually matters for the exchange rate, showed a surplus of near $400 million for the year, meaning that—at the prevailing exchange rate—Ethiopia could more than fully cover all its foreign exchange outflows from its available supply of foreign exchange.

- **Reserves**: A tell-tale sign of an incorrectly valued exchange rate is when a country's foreign exchange reserves are falling sharply and reaching a low level. This was indeed observed in Ethiopia in 2007/08, but has not been the case for two years now. Reserves rose in FY 2008/09 (from $906 million to $1524 million) and rose again in the just completed fiscal year from $1524 million to $1901 million. The latter figure is about 2.1 months cover, which is not a particularly high safety coverage, but far from indicating crisis conditions that would call for a sharp exchange rate adjustment.

- **Debt sustainability**: Rising debt ratios can also signal an incorrect exchange rate to the extent that a country addresses its balance of payments problems by avoiding exchange rate devaluation and simply accumulating more debt. In Ethiopia's case, debt levels have risen in recent years but thanks to a large external debt reduction under the IMF/World

[1] Access Capital's 2010 Macroeconomic Handbook released back in March had projected an exchange rate of 13.52 for end-June 2010, virtually identical to the actual outturn of 13.53 per USD. In addition, we correctly anticipated a devaluation early in the new fiscal year, stating in our report that "we think the timing of the step exchange rate adjustment in the new fiscal year will be in the first quarter (July-September 2010) as the authorities will be keen to provide an added boost to exporters from the very beginning of the year". However, we clearly misjudged the magnitude of the devaluation (forecasting 5 percent instead of 20 percent) on the expectation that the authorities would, at most, move to close the prevailing gap with the parallel market. (See www.accesscapitalsc.com for Access Capital's 2010 Macroeconomic Handbook.)

Bank-led HIPC Initiative, this is occurring from a very low base. Thus, total external debt is only around 19 percent of GDP and the external debt service ratio is just 4 percent of total exports.

- **Real Effective Exchange Rate**: Ethiopia's real effective exchange rate rose sharply in the four years to end-2008 (by 60 percent according to the IMF's latest staff report) and was in need of significant adjustment at the start of 2009. To address this, sharp depreciations of the currency began in early 2009, involving three step devaluations (10 percent in January 2009, 10 percent in July 2009, and 5 percent in January 2010) as well as gradual monthly depreciations (averaging 4.5 cents per month, or roughly 5 percent when annualized). Given these cumulative adjustments, most assessments of the exchange rate were that it was close to its 'appropriate' level. The IMF's annual exchange rate assessments of all countries offer perhaps the most thorough empirical review of the appropriate value of an exchange rate, and the conclusion in this regard was that the Ethiopian Birr was broadly at an appropriate level, though perhaps in need of a modest adjustment of 7-10 percent (see Box below).

IMF Article IV Report on Ethiopia: Assessment of the Level of The Birr

The IMF assessment of the appropriate level of the Birr (See Ethiopia's Staff Report at www.imf.org) found that some adjustment in the exchange would be helpful to diversify exports and boost the export-to-GDP ratio, which is still at a low 6 percent of GDP. In addition, based on inflation differentials with partner countries and on what is a desirable reserve coverage ratio, a depreciation of the exchange rate of 7 percent and 10 percent respectively was deemed to be warranted. However, both these quantitative estimates of the needed adjustment were "within standard error margins", i.e., indicating that the rate could just as well be close to its "appropriate" value. Moreover, the IMF's assessment of the exchange rate based on the debt outlook was indeed that "there is no need for an exchange rate adjustment to improve the debt outlook."

Taking into consideration all of the above factors, the overall verdict of the IMF staff's most recent macroeconomic assessment, as reported in their concluding staff appraisal, was that "nominal exchange rate adjustments of 2009/10 have helped bring the exchange rate broadly back in line with equilibrium."

- **Private sector access to foreign exchange:** The business community in Ethiopia, and importers most notably, have long suffered under a system of delayed and insufficient access to foreign exchange. Banks do not have enough foreign exchange to meet all their clients demands, and since they cannot freely adjust the rate (to match available supply with demand), foreign exchange is rationed and customers are obliged to wait in queues. The good news in recent months has been that the queue times have shrunk at most private banks and increasingly higher shares of customers' requested forex demand is being met. Our discussions with several large foreign corporates also revealed that their ability to repatriate dividends has improved considerably in just the past few months, with wait times reduced and larger shares of their approved repatriations being met by banks.[2]

In sum, virtually all metrics of judging the Birr's appropriate level did *not* point to a fundamental misalignment of the exchange rate. Perhaps most tellingly, as noted above, the bottom-line assessment of the IMF staff offered just a few months ago was that the exchange rate was broadly at the level where it should be. To the extent there was a need for some devaluation, it was of a modest amount and mainly to reduce queuing at banks as well as to close the small (but persistent) gap with the parallel market. Quantitatively, the needed adjustment was in the range of between 4 percent (if the parallel market served as a guide) to 7-10 percent (as judged by the IMF's empirical estimates of the needed Birr depreciation).

[2] Foreign corporates need the central bank's permission to repatriate profits and dividends. However, even with NBE permission to repatriate a given sum of forex funds, foreign corporates had not always been able to do so with the speed and in the amounts that they desired due to shortages of foreign exchange at commercial banks.

Why Now? Why So Much?

Given the apparently little justification for a large devaluation, what motivated such a seemingly excessive amount? Indeed, if the IMF's independent assessment is that the exchange rate was broadly at its correct level, why would economic policymakers see a need to be 'more Catholic than the Pope'? From what we observe in recent official statements as well as in emerging policy documents such as the draft Five-Year Growth and Transformation Plan, we see the following (more longer-term and structural) considerations driving the views of policymakers in this area:

- **Experimenting with a Deliberately Undervalued Exchange Rate—The "China Model":** Countries may choose to have an exchange rate that is deliberately more depreciated than its 'appropriate' level (i.e., deliberately undervalued) if they see export promotion and diversification as the single most important macroeconomic objective that overrides all other considerations. By deliberately cheapening one's currency, a country can consciously under-price its products (when export prices are determined domestically) or alternatively ensure that its exporters receive more local currency returns on their activities (if export prices are determined externally). The main effect of such measures is to move an economy's resources into export industries, whether it be entrepreneurs, labor, or capital.[3] The most well-known case of such a strategy is China, which has long been seen as maintaining an unduly depreciated exchange rate that gives its export products a competitive edge across the world. If such a calculation is behind Ethiopian policymakers' move, as might very well be the case given their close attention to Asia's economic success stories, then the sharp exchange rate adjustment is simply a clear and unmistakable signal that export promotion is the number one macro priority in the coming years. Of course, this rather extreme approach might seem unnecessary given the record-breaking export performance of the just completed year (exports grew by 38 percent to a never-before-seen $2 billion), but the policy view is evidently that export performance can and should be even better.[4] We think that policymakers' recent move has some element of this rather conscious attempt to mirror the "Chinese model" of exchange rate management, not necessarily for as an extended period as China has done, but certainly as an experiment.

- **Aggressive Import Substitution:** The desire to put in place a firm import substitution strategy has long been in the plans and wishes of policymakers for many years. Such a policy of replacing imports with domestic production can be encouraged in many ways, including through tax policies, tariff rates, and regulatory measures. However, nothing is probably quite as effective as raising the price of imports, and there is no more straightforward way to do so than adjusting the exchange rate. The simple logic involved here is that imports should be squeezed out and the best way to do so is to make them more expensive—not by just 5 or 10 percent, but by an amount (i.e., 20 percent) than can seriously alter ingrained consumption and importing habits.

- **A low inflation environment and a positive harvest outlook:** With a much reduced inflation outturn and a broadly positive outlook for the period ahead, the timing for a sizeable exchange rate adjustment is certainly favorable. Such a bold move would not have been entertained in the last year or two in the midst of very high inflation, but is now much more tolerable given the very low price rises seen in recent months (inflation in July 2010 was just 4 percent on a year-average basis and near 6 percent on a year-on-year basis), and in light of the positive food crop outlook following this year's good *kiremt* rains (as recently reported by the National Meteorological Agency).

Possibly providing a unifying theme and motivation for all of the above factors is the new draft Five-Year Growth and Transformation Plan that has been circulated in the past couple weeks. The plan has set ambitious targets in a wide range of areas, and it is natural to assume that the sharp exchange rate adjustment is in part driven by the need to provide a big push for achieving these targets.[5] The specific targets that would be helped by the sizeable devaluation include plans for launching whole new export industries in textiles and sugar (with each exporting $1 billion and $0.6 billion annually by the

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[3] Recent academic work, most notably by Dani Rodrik of Harvard University, provides some support for the use of an undervalued exchange rate in countries with significant institutional and structural constraints to growth. His empirical findings point to a strong correlation between undervalued exchange rates and per capita growth.

[4] See, for example, the IMF's observation in its recent report that the average five-year export growth of 19 percent per annum in Ethiopia has not been as strong as that of several regional countries such as Uganda (25 percent), Zambia (25 percent) and Rwanda (21 percent).

[5] Access Capital will shortly review the authorities draft Five Year Growth and Transformation Plan (which is currently under discussion and comment) and release this in a research piece.

end of the Plan period in 2015); raising leather product exports six-fold (to $0.5 billion annually); and doubling coffee and flower exports from current levels. More broadly, an exchange rate driven import substitution strategy would also support the targets being set for the Industrial Sector (which is to grow by 20 percent annually) and for overall investment (projected to rise from its current level of just 24 percent of GDP to near 32 percent of GDP). Seen from the perspective of these targets, the devaluation appears to be part of a broader strategy of reorienting the economy toward more investment, more industry, and more exports.

Impact on the Macroeconomy

What will be the impact of the exchange rate on key macroeconomic variables? In broad indicative terms, many of the trends already observed with the steady depreciations of the past year will be reinforced. Export growth should certainly continue to be strong again this year, though the 35 percent growth rate is unlikely to be repeated and exports will likely show a still strong percent growth in the mid-20s. Given the small share of exports in overall GDP, this change will not have a marked impact on GDP growth, which will be dominated by developments in agriculture and services. Imports are likely to be compressed even further than has been the case so far, and we think growth in the mid-single digits is the most likely outturn. Aided by this trade deficit adjustment, the overall balance of payments surplus should exceed last year's figure of near $400 million, and reserves should consequently reach well above $2.5 billion (around 2½ months coverage). The biggest positive improvement for business is likely to be in the reduced wait-times in accessing foreign exchange, which should become much more readily available for importers though of course at a much higher cost. On the negative side, inflation is bound to reverse its steadily downward trajectory of the past year. The extent of the inflation spike will partly be determined by the central bank's monetary policy response, but an inflation rate of (just) above 10 percent now seems all but assured for 2011.[6]

From a macro perspective, most of these trends are generally positive. A misaligned exchange rate was a major problem of the Ethiopian macroeconomy in recent years, and one that meant foregone income for exporters, disruptions to import-dependent businesses unable to secure foreign exchange, and an unwelcome reliance on non-market means of allocating foreign exchange. Moreover, given Ethiopia's stage of development, there is much to applaud from a depreciated exchange rate: it encourages local production instead of imports, investment instead of consumption, and the use of labor instead of capital. Seen from all these perspectives, there is a lot to be welcomed by removing even the slightest hint of an overvalued exchange rate.

At the same time, such an exchange rate shock to the system is not without serious downsides. First, the speed of the adjustment was extremely sudden and could have been implemented more gradually to help import-dependent businesses cope with the adjustment and transition costs. Second, while investment and agricultural/rural exports are clearly helped, there is a risk of doing so at the expense of an unduly severe compression of consumption and urban incomes. This will arise owing to inevitable price rises for fuel, imported foodstuffs, capital goods, vehicles, and the like—all of which are among Ethiopia's largest imported items.

So, on balance, did the most recent exchange rate move go too far? We think so, not least because most macroeconomic data suggested an appropriate exchange rate adjustment of at most 10 percent. Moreover, there appears to have been a very singular focus on the objectives of boosting exports and squeezing out imports, without necessarily having given due weight to many sub-sectors that will be adversely affected. Still, to the extent that the exchange rate move represents a willingness to entertain major shifts in economic policy orientation (see below), including potential reconsideration of areas where there has been limited reform, then the longer term implications may be more positive than appears at first sight.

Outlook for the Period Ahead

Given the authorities' demonstrated ability to surprise, the likely path for the Birr rate appears somewhat unpredictable from here on. This is in marked contrast to recent years when the trends were partly discernable and

[6] In this regard, the IMF's recent advice in its staff report to restrain reserve money growth (i.e., money creation by the central bank) is now all the more pressing since—as they note— this will be indispensable "to sustain a low inflation environment and support the elimination of the bank-by-bank credit ceilings."

predictable: for example, the monthly depreciation of 4 cents and the regular step devaluations at the start and mid-point of the fiscal year.

Our best guess on the outlook is that, after a two-year period of rather sharp movements in the rate, there will likely be both a strong desire and a solid case for exchange rate stability from here on. Overvaluation is clearly no longer an issue and we thus expect that the long-standing pattern of gradual 4-5 cents monthly depreciations will be discontinued. If pressed for a projection, we would hazard to say that the exchange rate will not move beyond Birr 16.5 per USD until the end of this fiscal year (June 2011). Indeed, we think the most likely exchange rate range for the remainder of this year and most of next year will be within the narrow spread of Birr 16.35-16.50 per USD. To the extent that this assumption holds, as we think likely, there will be at least one positive element that this exchange rate shock brings for the import-dependent business community, namely, the very low probability of yet another drastic exchange rate move for at least the year ahead.[7]

On broader exchange rate related issues, if such drastic policy moves are set to become a feature of the new Five-Year Growth and Transformation Plan, similarly bold moves would be welcome in at least three areas:

- First, a liberalization of the exchange rate *regime* itself deserves consideration. Ethiopia is currently classified by the IMF as having a "tightly managed exchange rate…with a de facto crawl-like arrangement." Important changes in this area could include, for example, giving banks greater flexibility to adjust exchange rates to get rid of the long waits involved in accessing foreign exchange and allowing independent foreign exchange bureaus (not necessarily affiliated with banks) to operate in the market. The latter are widespread throughout Africa and help draw in foreign exchange inflows to the formal financial system instead of into the black market.

- Second, flexibility in the foreign exchange regime should involve allowing the exchange rate to move up as well as down, i.e., let it appreciate when conditions warrant and depreciate otherwise so that the expected movement of the Birr is not always and forever just a one-way bet. This would be a desirable feature to have even if the relatively controlled exchange rate regime must be maintained. With such two-way flexibility, incentives will arise for individuals and businesses to hold on to Birr as well as foreign assets, thereby providing more support for the Birr rate than would otherwise be the case. That the Birr rate could actually appreciate seems inconceivable in the current Ethiopian setting, but this is more a reflection of exchange rate regime and could actually occur if and when FX inflows from items such as foreign investment, remittances, or grants and loans are at exceptionally high levels during a particular season or year. Indeed, two-way movements in the exchange rate are common in many of Ethiopia's neighboring countries, with rates strengthening in periods when FX inflows are unusually high and weakening when the reverse is the case.

- Third, regarding the continued segmentation of the foreign exchange market when it comes to foreign exchange inflows from exports to China (which are currently restricted solely to the dominant state-owned bank), a decisive policy reversal would be welcome. The nature of Ethiopia's foreign exchange inflows and outflows is already highly uneven with many non-export receipts such as grants, loans, and foreign investment being channeled through the state banks. Any special privilege granted to state banks aggravates the situation, especially when private banks face a large share of the private sector's import demand. The current monopoly position of the dominant state bank to exclusively handle foreign exchange inflows derived from exports to China (now Ethiopia's biggest export destination) should thus be seen as a major obstacle to the emergence of a unified foreign exchange market and accordingly be eliminated.

In summary, if boldness is set to become the new theme in macroeconomic policymaking, the above three reforms deserve—in our view—just as much attention and consideration as did the exchange rate adjustment of September 1, 2010.

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[7] Much to our surprise, we note that the exchange rate depreciated even in the day following the major exchange rate adjustment — from Birr 16.3514 per USD on September 1, 2010 to Birr 16.3534 per USD on September 2, 2010. The day's change amounts to Birr 0.002. If a similar change occurs for all the 22 business days that the NBE sets its rates each month, then the implied monthly depreciation is Birr 0.044 (or 4.4 cents), virtually identical to the average monthly depreciation seen in the past year. Despite this, and mainly because of how significantly the exchange rate has already adjusted, we are inclined to believe that this one-day adjustment is unlikely to continue at this pace and will instead be fully discontinued or substantially reduced in the coming weeks.