monthly updates on the

ETHIOPIAN ECONOMY

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1. Introduction of New Currency Notes

On September 21 Ethiopia has begun circulating new currency notes. The last such change took place more than 20 years ago. For the first time in its history the country also introduced the 200-Birr note. Three months were given to exchange old notes with the new ones. Ethiopian authorities announced that the new design and security features on the new Birr notes will prevent counterfeiting. In addition to preventing/reducing counterfeiting, the change of currency notes is claimed to reduce the amount of money that is circulating in the economy outside the banking system and reduce inflation. In addition, the change is aimed at deterring cash hoarding that is thought to enables corruption and illegal business and transactions to thrive.

One immediate positive impact of the change of the currency notes has been its ability to draw the unbanked population to open and use bank accounts. For instance, within one month of the introduction of new currency notes, the government reported that at least 1.3 million previously unbanked Ethiopians have handed in their old banknotes and opened a bank account from which they can withdraw the new notes. According to the World Bank, only 35% of Ethiopian adults were said to have bank accounts in 2017, putting Ethiopia far behind other African countries such as Kenya, where the rate is 82%. A recent report by the government indicates that over the past year, the number of accounts in the country has increased by 31%. Despite the progress, the fact that half of the population still does not have a bank account indicates that a lot remains to be done to further reduce the proportion of the unbanked population in the country.

The impact of the currency note changes on corruption is not clear since, except for petty corruption, most corruption goes through financial institutions. Even when the corrupt money changes hands, there is nothing that bars the money from being deposited into bank accounts due to lack of a strong tracing, monitoring and accountability system. In addition, the idea of reducing inflationary pressures through change of currency notes does not hold much water. This is because there are several key drivers of inflation in Ethiopia such as currency devaluation, lack of capacity and low productivity in the economy to produce necessities in adequate quantities, excessive injection of money into the economy for instance through direct advances to the government by the central bank, etc. Even in the case of direct advance by the central bank to cover budget deficits ('printing money'), most of the new money that is injected into the economy takes the form of electronic entries in bank accounts and not currency notes.

Another justification for the change of the currency notes was to reduce the amount of money that is circulating outside the banking system in the country, which is estimated at around 11% of the total and about 109 billion Birr for the fiscal year that ended in July 2020. The amount of money outside of the banking system can be explained by the fact that most of the Ethiopian population uses physical cash for transactions.

New Currency Notes.
Source: ethiopianmonitor.com

2. Outlook on Economic Growth

The Ethiopian economy had registered a sustained and one of the fastest growth rates in the world for about 15 years – with GDP growth rates averaging about 10 percent per year between 2004-2018. This resulted in 6-fold increase in the per capita income of the population which stood at US$ 850 in 2019[1]. There has, however, been a slow-down of GDP growth particularly since 2018 and very pronounced in 2020 due to the impact of the coronavirus pandemic. Earlier in 2020, the World Bank had projected the Ethiopian economy to grow by 6.3% in 2020, which was later adjusted to 4% percent for the fiscal year ending in July 2020 and 0% for the current fiscal year. *The Global Economic Outlook 2020* published in October by IMF projected that the growth rates will decline sharply to 1.9% in 2020 and 0% in 2021 and growth returning to pre-crisis rates only in 2022.

Given the estimated population growth rate of 2.6 percent per year, the above GDP growth projection by IMF implies that real per capita income of Ethiopia is expected to contract during 2020 and 2021.

The projections of the Ethiopian Government have been more optimistic compared to the World Bank and IMF. It has been stated that Ethiopia's economy grew by 6.1 percent in the 2019/20 fiscal year that ended in July. It is to be noted that, the 10 Years Perspective Development Plan (2019/20-2029/30) sets a target of *10.2 percent average GDP growth rates over the 10 year period* in order to meet its target of raising the per capita income of the country to US$ 2,220 by 2030.

3. Continued Devaluation of the Birr

Over the course of October 2020, the Central Bank of Ethiopia (CBE) has continued the steady devaluation of the Ethiopian Birr. The official exchange rate between the Birr and US$ was devalued by 2 percent between October 01 and 31. (The currency was devalued by 1.4 percent in September 2020.) Between October 31, 2019 and October 31, 2020, the currency was devalued by a whopping 27.6 percent. The discussion below provides background to these developments and their implications.

For close to three decades, the Ethiopian Government has been implementing what it calls a 'managed floating' exchange rate regime. which means that the exchange rate has no predetermined path and thus it is allowed to fluctuate from day to day, with the authorities occasionally intervening in the foreign exchange market through the buying and selling of currencies. However, during all these years, the official exchange rate in Ethiopia has been fairly stable with about 5% nominal depreciation per year with exceptions of a few episodes of major devaluations (with not even single instance of appreciation). Consequently, the IMF to categorizes the exchange rate regime as a crawl-like arrangement, i.e. not 'managed float'.

[1] https://www.worldbank.org/en/country/ethiopia/overview

For many years, international financial institutions have been insisting that the Ethiopian Birr has been overvalued and therefore pushing the Ethiopian Government to devalue it to stimulate exports. The main idea behind this argument is that devaluation would enable exporters to make more money in the local currency for a given amount of sales abroad thereby encouraging them to export more. Meanwhile, devaluation would make imports more expensive (in local currency) thus discouraging imports. These two processes are supposed to improve trade and current account balances of the country by increasing exports and decreasing imports.

These arguments, however, assume that supply of exports and demand for imports are very flexible, i.e. that Ethiopia could export much more (and earn much more hard currency) when export prices rise in local currency and imports would significantly decline when their prices increase in local currency. In all episodes of significant devaluation in Ethiopia, significant increase in export earnings and decline in imports were never witnessed. On the export side, one reason is that there is no sufficient idle productive capacity (in factories, farms, etc.) and no conducive economic environment to quickly increase the quantity of exports when their prices rise.[2] On the import side, the Ethiopian economy does not have the capacity to replace imports when import prices rise. Moreover, a large proportion of imports are essential items (e.g. petroleum, medicines, industrial inputs, machinery, etc.), which means that an increase in their prices would not discourage imports. In other words, devaluation would simply lead to rise in price of imports (in local currency) thereby creating inflationary pressures rather than reducing the imported quantities. imported. Consequently, every one of the major devaluation episodes (including the current one that began around October 2019), has not resulted in improved export earnings and reduced import bills but in higher inflation. (To be discussed in detail in the next section.)

The gap between the official exchange rate and the illegal parallel ('black market') exchange rate has been the key 'evidence' used to argue that the Birr is overvalued and to push for devaluation. Unfortunately, every time the government has tried to align the official and black-market exchange rates through devaluation, the black-market rate has moved up and created significant black-market premium (about 24-27% over as of the first week of November 2020).

Complete floating of the exchange rate would also not resolve the challenge of shortage of hard currency reserves, which fuels the parallel exchange rate market since the shortage is structural. In fact, due to chronic trade deficit, high- import dependence and very low hard currency reserves, conditions of the country floating, the exchange rate will have disastrous long-term effects, including high uncertainty for those planning long-term investments; wild, unpredictable up/down swings in exchange rates; loss of an important industrial/trade policy tool for economic transformation; very likely scenario of high inflation; exacerbated inequality, worsened capital flight, etc.

[2] For instance, it takes many years for coffee trees– coffee being a major export item of Ethiopia - to be planted and substantially increase coffee supply.

4. Desert Locust Invasion

Since January 2020, swarms of desert locusts have damaged over 200,000 hectares of cropland in Ethiopia with devastating economic consequences for the people affected. According to data from the Desert Locust Control Organization for Eastern Africa (DLCO-EA), an invasion of this magnitude has not been seen in Ethiopia in over 25 years.[3] The locust invasion is threatening food supplies and livelihoods for millions of people. A total of 2.4 million hectares of farming and pasture lands are expected to be impacted, which may cause food insecurity. Furthermore, given the significant share of agriculture in Ethiopian GDP (33.3 percent in 2018/19[4]), the negative effect of locust invasion on agriculture is expected to translate into a significant slow-down in the growth rate of national GDP.

5. Developments in Price Levels and Inflation

According to official statistics, inflation averaged about 15.5 percent per year during 2005-19. During the last fiscal year's (July 2019- July 2020) average headline inflation rate stood at 19.9 percent, mainly driven by the growth of food inflation of 23.3 percent, while non-food inflation stood at 15.8 percent. Headline inflation, an indicator of the cost of living, stood at 18.7 percent in September 2020 and 19.3 percent in October 2020, according to the latest report from the Central Statistical Agency (CSA). The report shows that food inflation accelerated to 23.2 percent, a rise of two percentage points compared to the previous month.

One of the key underlying causes for sustained and substantial increase in prices and the cost of living in Ethiopia includes the expansion of money supply and government expenditures that have not resulted in an equivalent or greater level of expansion in production, productivity and production capacity in the economy. The economic slow-down due to the COVID-19 pandemic and the associated disruptions in production and local and global supply chains is also another major factor for the current inflationary pressures in the Ethiopian economy. A third major underlying driver for sustained rises in the cost of living in the economy is the ongoing and sustained devaluation of the currency (discussed above). It is to be noted that all major episodes of currency devaluation in Ethiopia have been accompanied and followed by substantial rise in the rate of inflation in the economy.

Both the Home-Grown Economic Reform and the 10 Years' Perspective Development Plan (2019/20-2029/30) of the Ethiopian government recognize inflation as one of the major macroeconomic challenges for the Ethiopian economy. Unfortunately, due to the ongoing political/security, the negative impact of COVID-19 and the ongoing creeping devaluation of the Birr, the rate of inflation is anticipated to remain high in the best-case scenario and to accelerate even further in the worst-case scenario.

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[3] The problem is not limited to Ethiopia with Eritrea, Somalia, Djibouti, Sudan and Kenya also being affected.
[4] Central Bank of *Ethiopia Annual Report for 2018/19* available here: https://nbebank.com/wp-content/uploads/pdf/annualbulletin/report-2018-2019.pdf

6. Developments in Inflow of Foreign Direct Investments

According to UNCTAD's latest *Global Investment Trends Monitor* released on 27 October, global foreign direct investment (FDI) flows fell 49% in the first half of 2020 compared to 2019, due to the economic fallout from COVID-19. The report indicates that, in the wake of the pandemic, lockdowns around the world slowed existing investment projects and the prospects of a deep recession led multinational enterprises to reassess new projects. The report also indicates that FDI inflows into Ethiopia were relatively stable declining by only 12% compared to the previous period and stood at US$ 1.1 billion during the first half of 2020. In comparison, Sub-Saharan Africa has experienced a 21 percent decline over the same period.

Information from Ethiopian Investment Commission, however, paints a less rosy picture of investment inflows over the second half of 2020. Specifically, during the first quarter of the current Ethiopian Fiscal year (which started in July 2020), some 36 FDI projects were registered raising US$ 500 million in FDI which represents a 20 percent decline from the targeted US$ 700 million. Moreover, given the ongoing political/security crises in Ethiopia, the inflows of FDI into are expected Ethiopia to be hit even much harder at least over the immediate future.