

THE MACROECONOMIC POLICY ENVIRONMENT AND PUBLIC ENTERPRISE REFORM IN ETHIOPIA

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1. INTRODUCTION

Ethiopia's economy has suffered from inappropriate policies and devastating war. To reverse the downward trend and facilitate an economic recovery and growth, a comprehensive reform program is under implementation. The Emergency Recovery and Rehabilitation Programme's implementation greatly contributed to the process of recovery.

Macroeconomic stabilization and structural adjustment measures have been taken since October 1992 involving an exchange rate adjustment and new fiscal and monetary policies as major components. The new investment, labor and public enterprise laws have been introduced to create new legal and regulatory framework consistent with the objective of moving towards a market economy.

As the result of the public enterprise reform, enterprises are expected to operate on a competitive basis. The transition from their current unhealthy status to commercially viable units will be a difficult but unavoidable exercise. An important role is to be played by the macroeconomic environment in which the public enterprise reform is to be effected, which influences the sequence, speed and modalities of the reform. Macroeconomic stabilization will increase the tension and pressure on the already financially strained public enterprises. This paper attempts to trace the likely implications of the exchange rate adjustment and the restrictive fiscal and monetary policies on the public enterprise reform programme.

Section two describes the macroeconomic environment in Ethiopia, while Section three looks at the economic reform and other accompanying measures taken so far. Section 4 treats the new economic policy framework vis-a-vis public enterprises and section 5 attempts to look into the interaction of macroeconomic stabilization and public enterprises reform process.

2. THE SETTING

The Ethiopian economy is in a worse shape in the 1990s than it was in the 1970s. During this period, GDP grew only by 1.5 per cent, implying a declining per capita income. The decline in GDP was severe in the early 1990s as the table below shows (see Table I). The decline was 0.6 percent in 1990/91, while it was 7.4 percent in 1991/92. In line with this domestic savings declined, resulting in widened resource gap and consequently a growing indebtedness, which generated severe pressure on the balance

of payments. By the end of the 1980s, Ethiopia began to accumulate arrears. On a commitment basis, debt service ratio reached about 81 percent in 1991/92.

The low level of GDP growth also meant poor performance of exports, which coupled with fluctuation in external terms of trade resulted in severe foreign exchange shortage. As a result, the economy had come to a standstill, industries stopped or operated at very low level of capacity utilization, transport was disrupted, essential infrastructure remained unattended, and in the process inflation soared.

Table 1: . Selected Economic Indicators (in per cent)

	E F Y	1979	1981	1983	1984
1	Real GDP growth	9.5	1.6	-0.6	-7.4
2	Agriculture	15.2	2.2	8.0	-3.9
3	Industry	4.8	0.4	-16.1	-4.9
4	Inflation rate	-9.5	9.6	20.9	21.0
5	Money supply growth	8.1	9.0	18.6	13.3
6	percent of GDP Exports of Goods and Non Factor services	11.3	12.4	8.2	6.8
7	Imports of Goods and Non Factor services	22.3	20.0	18.4	16.1
8	Gov't revenue	25.1	30.1	19.8	15.7
9	Gov't expenditure	32.7	41.0	36.9	29.9
10	Domestic Savings	4.8	5.8	0.2	-0.5
11	Gross Fixed Investment	15.8	13.4	10.4	8.8

Source: Ministry of Planning and Economic Development.

The economic decline was accompanied by a social crisis involving millions of displaced persons, refugees, demobilized soldiers and the unemployed. The health system came under severe pressure due to lack of essential medicine, which was the consequence of foreign exchange crisis.

Public enterprises have an important role in the Ethiopian economy as they had a dominant position during the Dergue years resulting from the policy of building a

socialist economy. The objectives of establishing public enterprises included - to mobilize resources for large scale investment and to establish control over the major means of production and distribution.

Public enterprises in Ethiopia are usually viewed negatively, neglecting their important positive contributions. They have made considerable contribution to domestic capability building notably in air and sea transport, mining and energy, telecommunication, construction, manufacturing industry, and modern agriculture.

Their fiscal contribution is also quite significant. During 1986/87 - 1988/89 the total residual surplus paid by enterprises was equivalent to about 86.5 percent of domestic savings, 33 per cent of total fixed investment, 17.5 percent of central government total revenue, and 26 percent of tax revenue. This indicates that public enterprises are important sources of resource mobilization. Furthermore enterprises have in no small measure contributed to employment creation. During the 1979/80 - 1988/89 period the total employment generated was about 264 310 indicating that on average, 26, 431 new jobs were created per annum [MPED 1993].

All these point to the fact that the state of public enterprises is an important variable for the performance of the Ethiopian economy. Towards the end of the 1980s and early 1990s their situation has deteriorated as did the overall economy.

Public enterprises were generally constrained by the following factors: lack of management autonomy, foreign exchange shortage, and lack of inputs. These have seriously constrained capacity utilization of enterprises, which varied from sector to sector and from enterprise to enterprise. Capacity utilization of industrial enterprises, for example declined from an average of 82 per cent in 1987/88 to about 41 per cent in 1991/92 [MPED 1993]. Likewise, public enterprises budgetary contribution in terms of residual surplus has continuously declined from about 685 million Birr in 1987/88 to about 259 million Birr in 1991/92.

With declining capacity utilization and low output levels, losses of the public enterprises have been increasing which has led to increased pressure on the budget and the financial system, intensifying the crisis in this area. Their outstanding debt has been increasing leading to deterioration in their debt to asset ratio. This can be observed from the following table (Table 2) The situation is worse in the state farms.

Table 2. Industrial Enterprises and State Farms Average Debt Ratios 1991/92 (In Mn Birr)

	Total Asset	Total Liabilities	Average Ratio
1. Industrial Enterprises	2395.5	1615.2	0.67
2. State Farms	1495.2	2190.7	1.47

Source : MPED, January, 1993

3. THE ECONOMIC REFORM

Ethiopia is currently in the middle of economic reform designed to correct the severe internal and external imbalances built over the last two decades as briefly touched upon in the earlier section. The economic reform aims to revitalize the economy and create conducive macroeconomic and sectoral policy environment for development, and create market - based economy.

In the early phase, the accent is on rehabilitation, which is being effected through Emergency Recovery and Reconstruction Programme (ERRP). Once the ERRP was launched, it was followed by macroeconomic and structural adjustment measures to effect macroeconomic stabilization and lay the foundation for sustained economic growth. Accordingly various measures have already been taken including the following.

- a) devaluation of the Birr by 59% in terms of foreign currency on October 1, 1992.
- b) introduction of an auction system on May 1, 1993 for foreign exchange;
- c) upward adjustment of interest rates and elimination of distinctions between private and public sector that used to favor the latter;
- d) introduction of new investment, labor and public enterprise laws;
- e) restrictive fiscal policy reducing budget deficit;
- f) elimination of all export taxes, except on coffee, to encourage exports;
- g) revision of personal income tax to raise the minimum level for taxation, reduce the number of tax brackets and lower the highest marginal tax rate from 85 to 50 per cent;

- h) reducing non - corporate tax rate from 89 to 59 per cent to give investment incentive and also to minimize evasion;
- I) deregulating transport and freight tariffs; and
- j) public sector salaries were adjusted upwards with higher percentage adjustment for lower income group and the freeze on public salaries were also removed.

All these do affect public enterprise reform - speed and modalities, issues that we take up in the following section.

4. PUBLIC ENTERPRISE AND THE NEW ECONOMIC POLICY STANCE

The new policy stipulates that public enterprise will have full autonomy and their performance will be judged by profitability. They are expected to compete with the private sector and they will not be awarded special privileges. This is a major policy shift. Some enterprises will remain within the state sector while others will be privatized. The policy stance for chronic loss makers is liquidation.

To implement the policy, as indicated earlier, a new Public Enterprise Law has been issued. The Law has established a Supervising Authority and Management Boards for Public enterprises to increase their autonomy. The former supervision and management structure has been abolished - notably the various corporations.

Categorization of public enterprises by their ultimate status is being worked out. This work will identify enterprises that will be privatized in the short, medium and long - term. Privatization is not an easy task especially in the Ethiopian context [see Eshetu 1992]. The domestic private sector is, for all practical purposes, in its infancy. The problems of implementation and the absence of developed financial sector do impact on privatization in Ethiopia.

The experience of other countries shows that the progress is modest. During the 1980 - 1991 period about 7000 public enterprises were privatized, the major part, (4500) is in the former East Germany [UNDP 1993]. As far as developing countries are concerned, the record shows about 1400 privatized enterprises.

Besides preparing the groundwork for restructuring and privatization of public enterprises in Ethiopia, several actions have been taken to address problematic enterprises. Notable in this regard is the liquidation of the Ethiopian Building Construction Authority. The Ethiopian Domestic Distribution Corporation and Ethiopian Import Export Corporation were rationalized to create single public enterprise. Through restructuring, the Council of Ministers has issued regulation for the establishment of public enterprises in manufacturing industry, trade, hotels and tourism and construction. Others are expected to follow soon.

Table 3. Privatization of Public Enterprise 1980 - 1991

R E G I O N		Enterprises Privatized	Share of Total Privatization %
1.	Eastern Europe of which former GDR	5305 4500	78 66
2.	OECD countries	170	2
3.	Latin America and the Caribbean	804	12
4.	Sub-Saharan Africa	373	5
5.	Asia	122	2
6.	Arab States	58	1

Source : UNDP 1993, p.48

Along with restructuring and the preparation for privatization, retrenchment and redeployment strategies are being worked out to cope with the negative effects of adjustment.

The economic environment in which public enterprise reform is being carried out, and the speed of doing so are important areas of concern determining the success of the process. It is difficult to envisage market orientation, privatization and restructuring of public enterprise if there is no right economic environment. In this respect a number of macro-economic policy reform measures have been taken as we tried to highlight in the earlier part of this paper. The next section attempts to address their implications on the pace and modalities of public enterprise reform.

5. THE MACROECONOMIC STABILIZATION AND PUBLIC ENTERPRISE REFORM

In a drive to create a market oriented economy and lay the foundation for sustained development an economic reform program is during implementation. The reform program included macroeconomic policies, a substantial adjustment to the overvalued official exchange rate, adjustment in interest rate, and other monetary and structural reforms indicated earlier.

So far, the performance under the program has been quite positive. In 1992/93 GDP is expected to show a strong recovery due to better agricultural, industrial, construction

and transport activities. Real GDP is expected to show a 7.6 percent growth. Export performance has also shown a rebound; which with the debt relief obtained from the Paris - Club has helped to relieve the pressure on the balance of payments. The availability of foreign exchange through ERRP has especially contributed to industrial recovery.

This recovery with the process of creating new legal, regulatory and incentive system is bound to assist the effort to reform public enterprises. The recovery, induced by the reform, will improve the foreign exchange availability, which in turn, will enable enterprises to operate at or near full capacity. This would improve their efficiency and financial position.

Exchange rate action is also expected to benefit labor - intensive enterprises and those that produce for exports and imports to substitute. Many enterprises in the manufacturing sector have the potential of increasing their exports and developing strong backward linkages with agriculture.

Further, the elimination of export taxes, the simplification of export and customs procedures will help to expand exports. Thus, it will contribute to the increased efficiency and competitiveness of public enterprises. These are all on the plus side and not all public enterprises are expected to benefit from this. Those that are heavily dependent on imports are bound to face increased burden from the stabilization measures. In a situation where public enterprises are in financial distress, macroeconomic stabilization generates tension and pressure at least in the short - term.

As the government designs its exchange rate policies to satisfy overall macro - economic policy goals, export intensive and import - intensive enterprises go through feast and famine cycles respectively. In the process, some will be driven to bankruptcy. High interest rates threaten bankruptcy along with exchange rate reform and import liberalization. Take, for instance, the case of upward interest rate adjustment. Lending rates have jumped from 5 - 8 per cent to 13 - 14 per cent. This action increases interest payments on working capital of public enterprises adding to the financial pain and eventual loss of enterprises. This is because until recently enterprises have been operating under very low capacity that resulted in less output and exacerbated financial position of enterprises.

Exchange rate adjustment also exacerbates their financial position. They need more working capital to finance their imports. The implication is serious. Let us illustrate with a hypothetical example. Say there is an enterprise A in the chemical sub sector whose import demand amounted to say 60 million Birr before devaluation. Assuming its import demand remained constant in dollar terms, after devaluation the firm requires about 145 million Birr. Given the general financial distress explained earlier, the firm may not be able to raise so much money. The Banks may not lend the firm for its lending policy is related to profitability in line with the reform. In such a condition, the firm may be forced to reduce its demand impinging on its capacity utilization and future life.

The effect of exchange rate adjustment is not only confined to imported inputs of enterprises but it also affects enterprises through import taxes that remained unadjusted after devaluation of the Birr. The amount that enterprises pay for import taxes would increase in line with the rise in import prices of inputs in Birr terms.

If the banks refused to finance enterprises, because they are under financial stress, enterprises will collapse leaving behind massive unemployment and mountain of debts owed to domestic banks, eventually the state budget will be forced to take the heat, thus, conflicting with the objective of fiscal stabilization measures. This has also political and social dimensions that impinge upon the sustainability of the reform. The implication is that macroeconomic and public enterprise reform is an elusive and tricky task. The sequencing, pace and modalities of reform need careful handling.

Of course, public enterprises could increase their output prices to cope with the cost pressure generated by interest rate and exchange rate adjustment. In terms of the objective of the reform this is not an option since enterprises operate at low capacity. Output prices should be tied to improvement in capacity utilization. Meanwhile, banks need to have permissive credit policy stance towards public enterprises, since they owe the banks much money any way - an issue that will invariably involve the central government treasury for cleaning the portfolio of the banks.

If price adjustment is not advisable from efficiency consideration, enterprises could look for ways of reducing costs. Given the general presumption that enterprises are over staffed, they can adjust by reducing their labor force and therefore wage bill. This may entail massive retrenchment, which could generate social tension endangering the reform process in its early phase. The demand for budgetary resources would increase especially to finance the severance pay for retrenched labor. This conflicts with the objective of the reform in its early phase-restrictive fiscal stance.

Realizing the fiscal burden that could arise from distressed enterprises, the state could opt for large-scale privatization. The immediate question is: Are they fit for sale? The state could auction - off some retail shops, but that is not the end of the story. As experience from other countries has shown, privatization is a slow and complex process and there are many constraints in Ethiopia [Eshetu, 1992, MPED 1993].

Privatization is not also free from the problems raised earlier, unemployment and price increase since with privatization the management has acquired the freedom to freely determine output prices.

All these show that the path of reform is full of hard and delicate choices. This suggests a phased program of public enterprise reform. The primary task is to relieve their foreign exchange constraint and therefore their problem of raw materials and spare parts. This would allow them to increase their capacity utilization, output and sales revenue. This is broadly what is being done through the economic reform programme.

Another area that provides conducive background for public enterprise reform that needs early action is the creation of a new legal, regulatory and institutional framework. In the Ethiopian economic reform program this is an area for up-front actions. Several measures in this area have already opened wide opportunities for private sector that is necessary to develop a competitive market.

According to the information from the Investment Office, between July 1992 and March 1993 alone, private sector investment (those that received license) amounted to about 2.1 billion Birr. This is for investment level of 250,000 Birr and above. The investment directed towards the manufacturing sector accounts for a larger share - 36 per cent followed by real estate, hotels and tourism, mining, agriculture and construction.

Greater autonomy to management has also been accorded that would allow it to look for cost reduction measures, diversification, changing internal work organization and working habits, and strategic planning.

To take effect, it may take time and may not be visible initially as enterprises warm - up to the new environment. Workers in public enterprises also cannot ignore the emerging economic environment and will strive to improve efficiency since the government has given clear signal that it will no longer guarantee their jobs.

All these pave the way for smooth restructuring of enterprises. Actions in these areas are meant to strengthen enterprise to survive in the marketplace and increase their readiness for privatization - an area of economic reform that is bound to increase in scope at a later stage of the reform process.

It is important to note that public enterprises in Ethiopia had been operating in an essentially war economy. They were made to meet economic and socio - political objectives that are usually conflicting. A major part of the problem was not of their own making - it was externally imposed - such as foreign exchange constraint. Like their counterparts in other developing countries they had not got the chance to operate in a normal economic environment. This suggests that the focus of the reform in the early phase have to be on creating conducive economic environment. This is the broad direction. It does not exclude early action in privatizing simpler and obvious cases and liquidating the worst cases. Public enterprise reform is likely to be protracted and for it to be effective should be planned in a successive of stages. The thrust of the early phase is bound to be restructuring to smoothly handle the tensions and pressures generated by macroeconomic policy reform.

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