The State of Major Macroeconomic Indicators
in Ethiopia and Proposed Directions[1]

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1. Introduction

The current state of the Ethiopian political Economy can best be captured by the contrast between the promise of the ruling party and people's high expectation from the new administration which was inaugurated on October 4, 2021. On the economic front, the country is facing both internal and external disequilibria and subsequent macroeconomic instability. Given the security, economic and political conditions in which the country is in, the new administration led by Prosperity Party carries enormous task, a burden that comes with electoral victory.

In light of this, this paper tries to examine the current state of the Ethiopian economy and indicate the way out from the impasse. The first section of the paper briefly appraises the current state of affairs pertaining to the economy by focusing on macroeconomic management. This will be followed by identification of major challenges arising from the presumed deficits. The final section will outline the way forward and provide recommendations for policy consideration.

2. The Current State of the Ethiopian Economy

In the historical progression, the main macroeconomic policy objective of the Five Year Growth and Transformation Plan (GTP) was to achieve a rapid, sustainable and broad-based economic growth. It was observed that during the first four years of GTP implementation (i.e., 2010/11 to 2013/14), real GDP growth rate averaged 10.1 per cent, slightly lower than the target set for the period, which was 11 per cent. The major economic sectors of Ethiopia are agriculture, industry and services. The shares of agriculture, industry and service in GDP during this period were about 43 per cent, 12 per cent and 45 per cent respectively. During the reported period, agriculture, industry and services have registered annual average growth rates of 6.6 per cent, 20.0 per cent and 10.7 per cent respectively. The figures tell that all

[1] A discussion paper prepared for a workshop Good Governance Africa-Eastern Africa organized under the theme "The Burden of Victory" which was held on 10 February 2022.

sectors registered positive and significant growth. In Ethiopia, agriculture has been contributing to both output and employment.

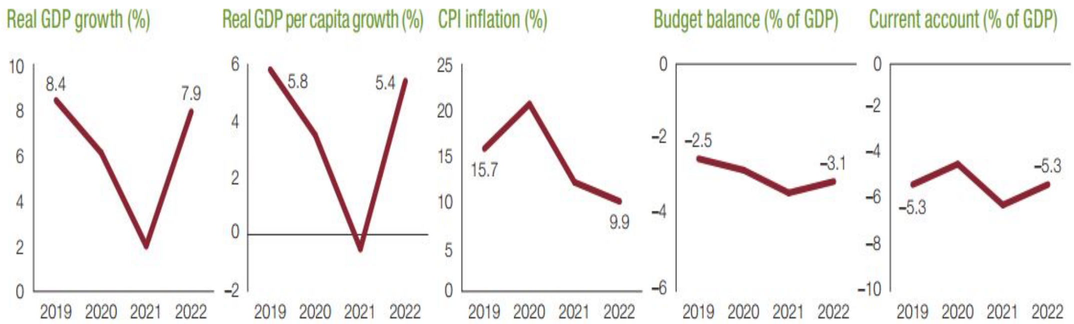
The Ministry of Finance and Economic Development (2014) noted that the service sector was closing gaps in terms of output share but remained far behind agriculture in employment. Structural change in the form of shift from agriculture to industry has not been observed so far. The observed shift was rather from agriculture to services, where expansion of the wholesale and retail trade, real estate, renting and related business were found to be the driving forces. The share of the service sector to GDP increased from 38 per cent to 45 per cent in the past 10 years, while the share of agricultural declined from 52 per cent to 43 per cent in the same period. However, agriculture will continue to be the main source of employment as the service sector has not been able to generate significant employment opportunities. This implies that the productivity of the much fewer service sector workers far outweighs labour productivity of the large number of people employed in the agriculture sector. It is well known that the creation of employment in service sector is more expensive than in agriculture and also service sector provides employment mainly to skilled labour. It also means that the quality of jobs and wages/incomes in the service sector is higher than those in the agriculture sector. In this context, measures to raise productivity in the smallholder agriculture as well as to boost private investments in commercial agriculture are imperative to growth.

According to the African Development Bank (ADB)[2], Ethiopia's economy grew by 6.1% in 2020, down from 8.4% in 2019, largely because of the COVID–19 pandemic. Growth was led by the service and industry sectors, while at the same time the hospitability, transport, and communications sectors were adversely affected by the pandemic and the associated containment measures to prevent the spread of the virus. The fiscal deficit, including grants, increased slightly during 2020, which was financed mainly by treasury bills. Tax revenue increased by 16%, but the tax-to-GDP ratio declined to 9.2% in 2020 from 10% in 2019 due to delayed implementation of tax reforms. ADB further noted that total public spending

[2] https://www.afdb.org/en/countries/east-africa/ethiopia/ethiopia-economic-outlook

remained stable, in line with the country's fiscal consolidation strategy. In 2020 inflation reached 20.6%, well above the 8% target, due to pandemic-induced supply chain disruptions and expansionary monetary policy. In November 2020, the official exchange rate was devalued by about 8% to 35.0 Birr per US dollar.

Furthermore, export revenues increased by 12% in 2020, as exports of gold, flower, coffee, and *Khat* increased while imports declined by 8.1%. This helped narrow the current account deficit to 4.4% in 2020 from 5.3% in 2019. Gains from service sector exports declined by about 6%, mainly because of decline in earnings by the Ethiopian Airlines. Foreign direct investment (FDI) fell from 20% to 2.2% of GDP, and personal remittances declined by 10% to 5.3% of GDP. Poverty was projected to decline from 23.5% in 2016 to 19% by the end of 2020. But pandemic-driven job losses, estimated at about 2.5 million, impede poverty reduction, according to a report by The African Development Bank, 2022. The following figures demonstrate the above discussed facts in graphs.



Source: Data are as of December 2020 and are from domestic authorities; figures for 2020 are estimates and figures for 2021 and 2022 are projections by the African Economic Outlook team.

The medium-term economic outlook is contingent on the resolution of the COVID–19 crisis, the pace of the economic recovery, and such other shocks as civil strife and climate change. Real GDP growth in 2021 was projected to fall to 2%, and then recover to about 8% in 2022, led by a rebound in industry and services. Monetary policy is expected to remain flexible in response to the government's financing requirements. Increased use of open-market operations is expected to reduce inflation gradually. The fiscal deficit is projected to increase as tax policy reforms are delayed due to COVID–19. The current account was likely to deteriorate in 2021, before improving in 2022 as service exports gradually pick up. The key downside risks to the economic outlook include low investor confidence, in part due to sporadic domestic conflicts, weakness in global growth, and climate change.

The statistics of the previous two decades showed significant economic growth accompanied by creeping inflation to the mid-2000s, but from 2005, growth was accompanied by trotting inflation. Despite the fiscal and monetary policies to contain inflation to a single digit during the Growth and Transformation Plans (GTP I from 1995/96-2010/11 and GTP II from 2010/11 2014/15), inflation persisted to the extent that real interest rates fell within negative territory. The official inflation records were 2.5% up to 2004 and 15.1% thereafter. While GTP II envisaged 11.1% economic growth, the performance stood at 10.9%. According to the Central Statistical Agency (CSA), in October 2019 the regional distribution of Consumer Price Index (CPI) shows that inflation reached 37.1 % in Dire-Dawa city. This was followed by Harari and Addis Ababa with 32.3% and 28.6% respectively. Despite overall economic growth, inflationary pressure affected the great majority of the population with an estimated average welfare cost of Birr 22.354 billion. Such inflation growth dilemma has severe implications for the welfare of wage earners and pensioners on fixed incomes which are not subject to wage or income indexation in the context of Ethiopia.

3. Major Challenges Arising from the Deficits

For the last two decades, Ethiopia has registered one of the fastest economic growths in Africa, but this has been accompanied by double digit inflation for most of the time. This growth inflation dilemma has led to heated discourse in academic and political circles. Understanding the drivers of internal and external gap as well as explaining the inflationary growth process occupied a central position in the discourse on the political economy of Ethiopia.

Domestic disequilibrium (imbalance) covers the gap in resources which are the result of such items as budget deficits and saving-investment gaps. The revenue-expenditure section of the National Income Account reveals that for the period 1974-2017, the annual resource gap (budget deficit), including and excluding grants, averaged 8,492.971 and 14,493.69 million Birr respectively. For the year 2017, the figures were 66643.18 and 84557.13 million Birr respectively. The annual total expenditure for the whole period averaged 124 % of total revenue, with 123% for 2017. For the same period (1974-2017), the budget deficit, including and excluding grants, were positively associated with general inflation, non-food inflation and food inflation, with correlation coefficients of 4.09%, 1.56% and 12.64% respectively. The coefficients for the budget deficit excluding grants were 11.11%, 7.21% and 24.59% for general, non-food and food inflation respectively.

On the sources of finance for the whole 1974-2017 period, the annual average for gross borrowing, external sources and domestic borrowing was 5,448.625, 4,663.038, 2,140.716 million Birr respectively. For the period 1974-1990, the figures averaged annually 343.3905, 297.4992 and 396.0675, million Birr respectively; and the corresponding values for 1991-2017 were 8663.032, 7411.711, and 3239.199 for gross borrowing, external sources and domestic borrowing respectively.[3] The World Development Indicator (WDI) for the period, for which data is available, 1990 -2013, showed the annual average domestic demand for investment and net saving were respectively 8 billion and 4.37 billion Birr. This signalled saving investment disequilibria of 3.63 billion Birr. The annual average of net borrowing during the same period was 13.7 billion Birr.

The data from the National Bank of Ethiopia shows that for the period 1974-2017, the annual averages of inflation and growth of broad money stood at 9.84% and 16.45% respectively. For 1974-1990, the averages were 8.32% and 12.54% respectively; and for 1991-2017, the average inflation and average growth rate of broad money were respectively 10.76 and 18.60%. Cost of food in Ethiopia increased 38.90 per cent in November of 2021 over the same month in the previous year. These figures clearly demonstrate the existence of domestic macroeconomic imbalances and their association with inflationary pressures in Ethiopia.

3.1. External Disequilibria

According to the International Development Association's Joint Bank-Fund Debt Sustainability Analysis (IDA/IMF (2018)), Ethiopia continues to be at high risk of external debt distress, and,

[3] See *Atnafu, 2020, Inflation Dynamics and Macroeconomic Stability in Ethiopia: Decomposition Approach:* Ethiopian Economics Association, *Policy Working Paper 06/2020)*.

consequently, is at high risk of overall debt distress. The external current account deficit (including official transfers) was estimated at 6.4% of GDP in 2017/18, but a gradual improvement of export performance, a moderate pick-up in capital goods imports, and steady inflow of remittances (even if slowly declining as a ratio to GDP) can lead to a gradual reduction of the deficit over the long term. Economic transformation, with more dynamic and diversified exports and a phase-down in public imports of capital goods, can be expected to ameliorate external imbalances.

On the issue of debt burdens, documents from the National Planning Commission reveal that, at the end of June 2019, total outstanding loans stood at USD 27.05 billion, 4.9% higher than the USD 25.80 billion in June 2018. The total outstanding loans to central government rose by 8.2% while non-government guaranteed loans decreased by 3.6%. Out of the total USD 2.77 billion disbursed in 2018/19, some 54.3 % were central government loans, and the remaining 13.6% and 31.9% were for government guaranteed and non-government guaranteed loans respectively. A total of USD 2.77 billion was paid for debt servicing, including the servicing of central government, as well government and non-government guaranteed loans (NPC, 2019). The yearly average balance of payment for 2013 to 2019 has been US 5,639.838 million with minimum and maximum values of US 2137.828 and US 7905.485 million respectively.

One of the key sources of inflationary pressure relates to how the government finances a deficit. Theoretically, a government can finance a deficit in three alternative ways: It can borrow from the public by issuing bonds to the public; it can print money which means borrowing from the central bank; or it can run down its foreign exchange reserves. In Ethiopia, these alternatives of financing deficit have varied from regime to regime. The dataset from the Ministry of Finance indicates that the average annual financing requirement for the period 1974-2017 was 8492.971 million Birr. The country's financing requirement for the periods, 1974-1990 and 1991 – 2017, were 720.279 and 13386.89 million Birr respectively.

3.2. The Level of Poverty and State of Inequality and Unemployment

The trends of poverty and income inequality from 1999/2000 to 2015/2016 have been improving in urban than rural areas, but with considerable variation across the different regions of Ethiopia. The decline of poverty with all measures was observed between 1995 and 2015/2016 with head count index of 33.2 in 1995/1996 declining to 14.8 in 2015/2016, poverty gap index declining from 9.9 in 1995 to 3.7 in 2015/2016 and with poverty severity index falling from 4.1 in 1995 to 1.4 in 2015/2016.[4]

Similarly, the level of poverty was substantially declining in urban than rural areas. In this respect, headcount indices in urban areas fell from 36.9 in 1999/2000 to 35.1 in 2004/2005, and further declined from 30.4 in 2010/2011 to 14.3 in 2015/2016. This was accompanied by the decline in rural poverty headcount indices which fell from 45.4 in 1999/2000 to 39.3 in 2004/2005 and further declined from 30.4 in 2010/2011 to 25.6 in 2015/2016. Despite such tremendous decline of poverty over the past years, the fact that a significant proportion of the population remains poor in rural areas indirectly show the prevalence of food insecurity in the countryside.

On the other hand, the trends of income inequality measured by Gini coefficient shows increasing trend from 0.29 in 1995 to 0.3 in 2010/2011 and rising to 0.33 in 2015/2016 with more inequality in urban than rural areas of Ethiopia. The rising trend of income inequality over time is not only exacerbating food insecurity, but also might obscure the short- to long-term effects of the government welfare-oriented planning. A higher value of the poverty gap indicates the terrible condition of the poor. In addition, the extents of food poverty with all measures are slightly bigger than total poverty due to the fact that the majority of poor household disposable income is allocated for purchasing food items. Poverty in medium-size towns is largely triggered by a lack of sufficient food at the household level.

Unemployment rate in Ethiopia increased to 19.1 % in 2018. The maximum rate was 26.4 % and minimum was 16.8 %. The unemployment level in Ethiopia stood at 20% in 2020, roughly about 22 million unemployed people which is equivalent to the total population of Florida State. Every year almost half a million new graduates are joining the labour market adding up to the existing stock of unemployed people.

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[4] Sisay Debebe and Efta Hizkiel Zekarias, "Analysis of poverty, income inequality and their effects on food insecurity in southern Ethiopia", in *Agriculture & Food Security, 2020, 9:16*)

3.3. Quality of Institutions as Challenge to Economic Performance.

This section tries to summarize the state of governance in contemporary Ethiopia. The state of governance can be measured in reference to its indicators which basically are multidimensional. To begin with, Corruption Perception Index in Ethiopia increased to 38 Index Points in 2020. The maximum level was 38 Index Points and the minimum was 22 Index Points. According to the International Governance Indicator, for Ethiopia Political Stability and Absence of Violence/Terrorism: was reported to be at -1.687 on a -2.5 to 2.5 scale in 2017.

Regarding rule of law, according to the World Justice Project, Ethiopia ranked 114th out of the 128 countries. In the survey that involved more than 130,000 households and 4,000 legal practitioners and experts around the world, Ethiopia showed improvement moving up six positions. The index measures rule of law performance across eight primary factors; constraints on government powers, absence of corruption, open government, fundamental rights, order and security, regulatory enforcement, civil justice and criminal justice. Ethiopia's overall rule of law score decreased by 5.6pc in this year's Index. Ethiopia's score places it at 26 out of 31 countries in the Sub-Saharan African region and 16 out of 19 among low-income countries. Significant trends for Ethiopia included improvement in the factors measuring constraints on government powers, open government, and fundamental rights, and deterioration in the factor measuring order and security, according to the report. Denmark, Norway and Finland topped the index.

4. The Way Out

The summary of the previous discussions requires two major reform directions from the economic point of view. These are stabilization of the macro economy by removing both domestic and external disequilibria and liberalization of the economy in tune to three binding directions. There is a generally accepted wisdom that the rate at which countries growth is substantially determined by three things: their ability to integrate with the global economy through trade and investment, their capacity to maintain sustainable government finances and sound money as well as their ability to put in place an institutional environment in which contracts can be enforced and property rights can be established.

Regarding inflation, which is one of the chronic macroeconomic constraints in Ethiopia, easing it requires not only domestic monetary policy, but also cultural transformation both from production and consumption sides. By consumption cultural transformation, we mean diversification of consumption and substitution towards non-mainstream feeding pattern. A case in point could be marginal movement away from *Teff*[5] and standard cereals towards other edibles. Another area of intervention in removing the structural bottlenecks in stabilizing prices is the establishment of independent consumers' associations. Such associations shall be established based on the free will of their members, instead of political motives. As they operate the associations needs to promote the free choice of members. Support to the consumers' associations may come from local governments, but with zero political interference.

As a general direction, the disappointing macroeconomic conditions require rehabilitation. Restoring macroeconomic stability requires as a necessary and sufficient condition to get-rid of the current conflict, which is a hindrance for rational economic reform. Likewise, policy makers need to focus on institutional changes that would enable subsequent economic rehabilitation, including removing domestic and external imbalances.

As there is strong evidence that the monetary component of inflation is money growth, prudent monetary policy shall include productive use of the available financial resources, tight monetary policy, and fiscal discipline allowing acceptable level of development financing. Further in this direction, insulating the Central Bank from political interference is indispensable. It helps the Central Bank to regulate domestic borrowing by the government particularly during election times, which often leads to inflation driven by political business cycle. Furthermore, the independence of the Central Bank is a necessary and sufficient condition to establish a well-functioning financial system, capable of finding high quality projects that can produce at a lower cost, and hence providing for lower inflation and increased competitiveness besides improving the welfare of individuals.

[5] *Teff* is the most common cereal crop used to make *enjera*, a flatbread which is a staple food in many Ethiopian households.

In reference to political economy, improving the quality of institutions and governance and zero tolerance to corruption are suggested as necessary conditions for fighting inflation, achieve enhanced welfare and make headway in economic growth with stable internal and external disequilibria. In the end, there is no universally accepted formula for successful dual transitions to democracy and economic freedom. However, experiences of different counties, for example Spain and the South Korea, and other recent studies provide us with rich theoretical insights that advance our understanding of how democratization and economic liberalization can be achieved in the aftermath of dictatorships. It has been learnt that the surest and safest path toward democratic consolidation and economic modernization is most likely to be charted by nations whose leaders wisely delay economic reform until at least some measure of democratic consolidation has been established. This approach is marked by technocratic proclivities that favour inclusion of social groups outside of state structures in the formulation and implementation of economic policy and compensation for those most directly affected by radical economic change. In this approach towards change politicians, bureaucrats, and civic leaders can construct a context of institutional and power relation capable of accommodating dialogue and compromise.[6] The foregoing arguments lead us to put the following takeaways for policy consideration.

I. First and foremost, there a need to remove domestic and external disequilibria; including controlling inflation, improving current and capital account balances (balance of payments);
II. That should be followed by institutional reform including ensuring rule of law and regulatory quality to create conducive investment climate, more specifically for guaranteeing property rights to attract investment;
III. Finally, effective integration into the global economy through trade and investment.

It should be noted, however, that these proposals are conditioned on political stability.

[6] See Stephan Haggard and Robert Kaufman (1996), "Voting for Reform: Democracy, Political Liberalization, and Economic Adjustment" in Comparative Politics, Vol. 28, No. 4. (July 1996), Pp. 477-492.

About the Author

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