Macro-Financial Policy: Ethiopia’s Experience and Lessons from China

Structure of the Presentation

- In part 1, we briefly highlight the experiences of China and Ethiopia in their comparable development phases.

- In part 2, we draw some policy lessons for Ethiopia and other similarly situated countries

Part I: Comparison with China

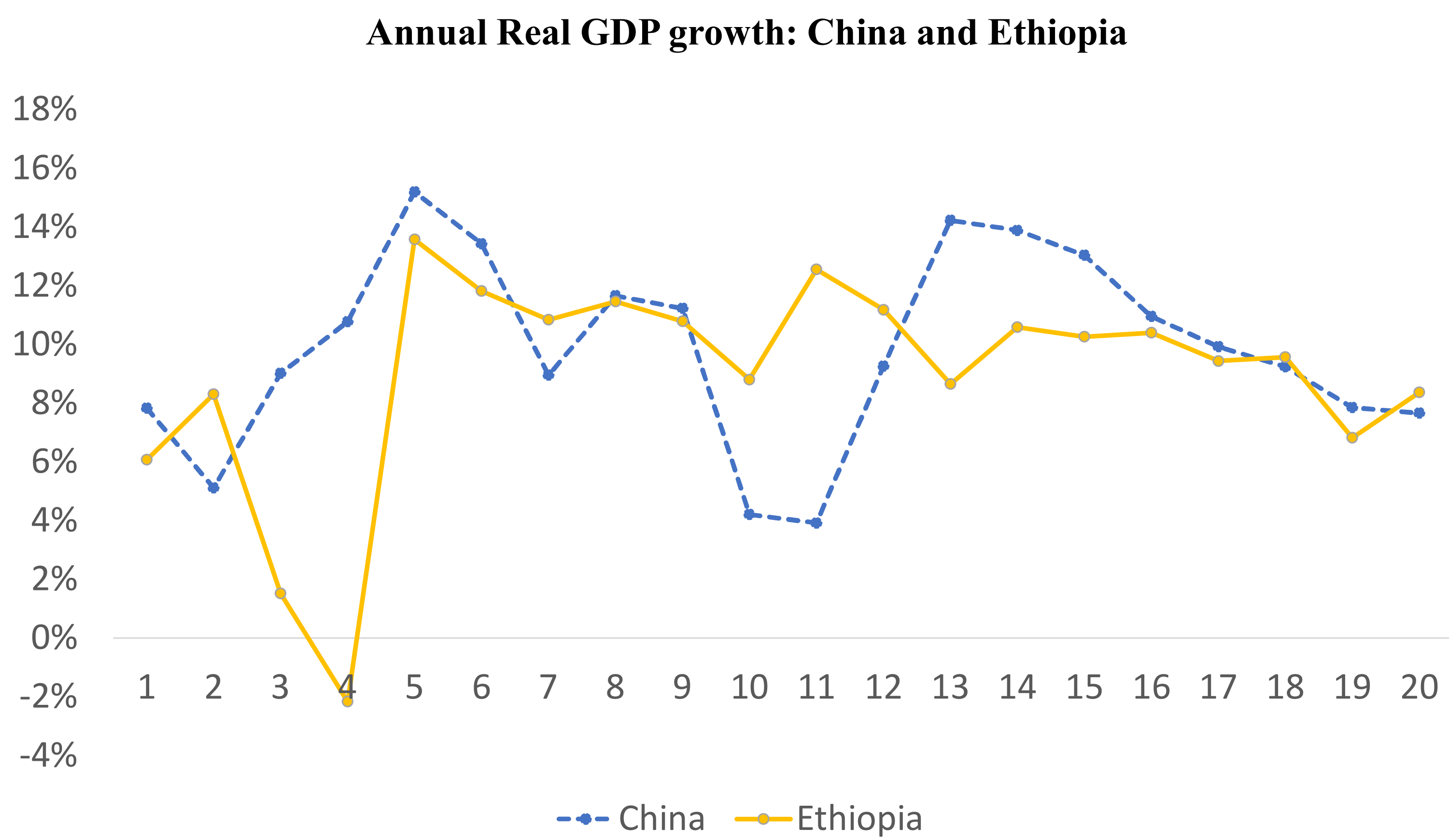
1980-1999 China and 2000-2018 Ethiopia

- China’s experience suggests that appropriate policies depend on the stage of development of the country

- Therefore, when comparing China’s experience with Ethiopia’s, we use the period 2000-2018 in Ethiopia and 1981-1999 in China.

- In the graphs we present in the following discussion, year 1 refers to 1980 China and 2000 in Ethiopia.

Similar GDP growth experience



Similar GDP growth experience

- The two countries have similar GDP growth performance in the comparison period.

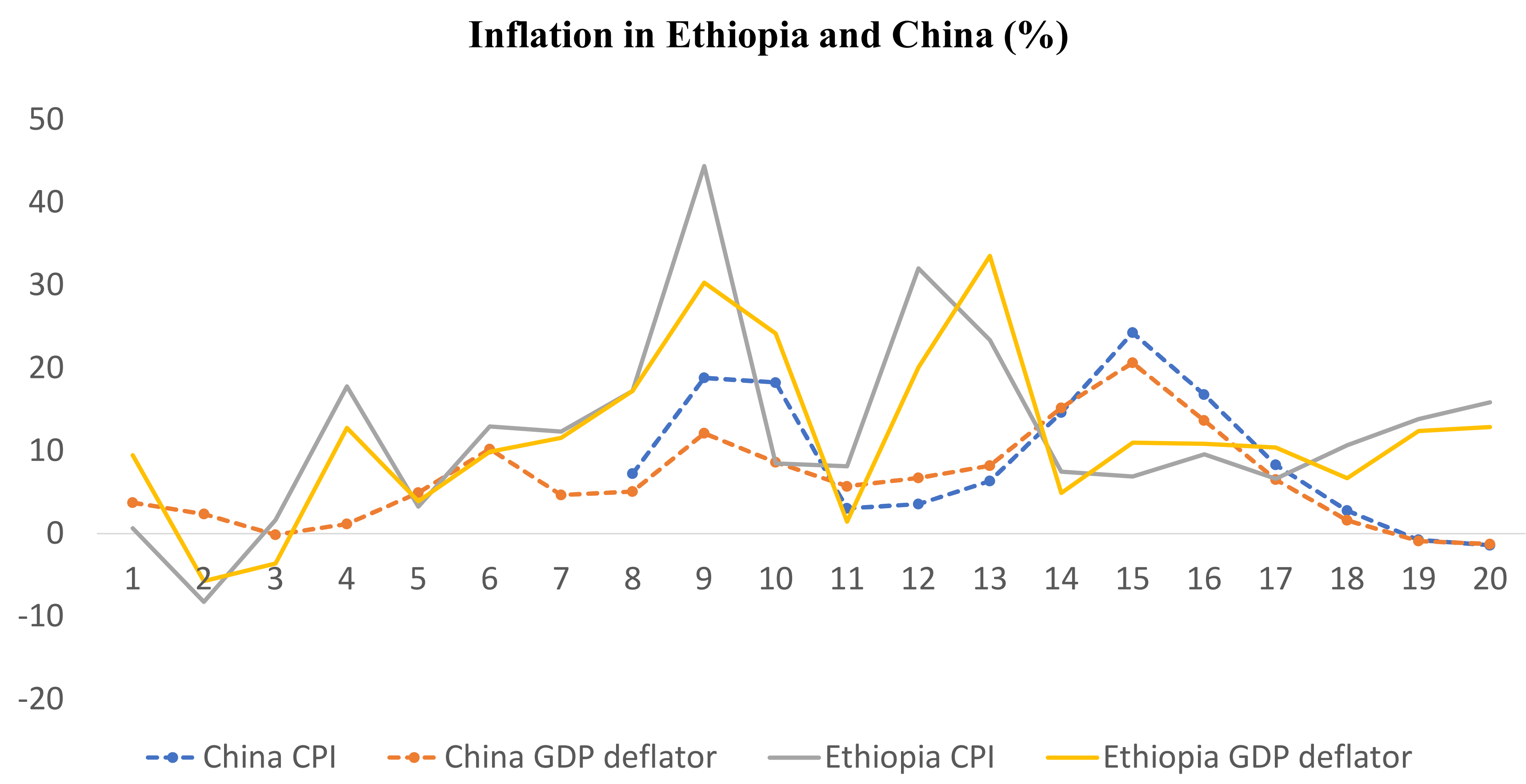
  - Ethiopia GDP growth: average=8.9%, standard deviation=3.6%
  - China GDP growth: average=9.8%, standard deviation=3.2%

- If we omit the drought in 2002/03, average growth in Ethiopia is 10% and standard deviation is 3.1%.

Different Structural Change in the Economy, Underperformance of the manufacturing Sector in Ethiopia

- The share of the agriculture sector declined by 14% in both countries
- In China, all of the 14% change is a shift towards the service sector
- In Ethiopia, the change is towards industry (construction specifically).
- In fact, in Ethiopia the manufacturing sector’s share declined (from 9% to 6%)
- In comparison, the share of the manufacturing sector in China was 30% by 1999.

Higher price stability in China



Higher price stability in China

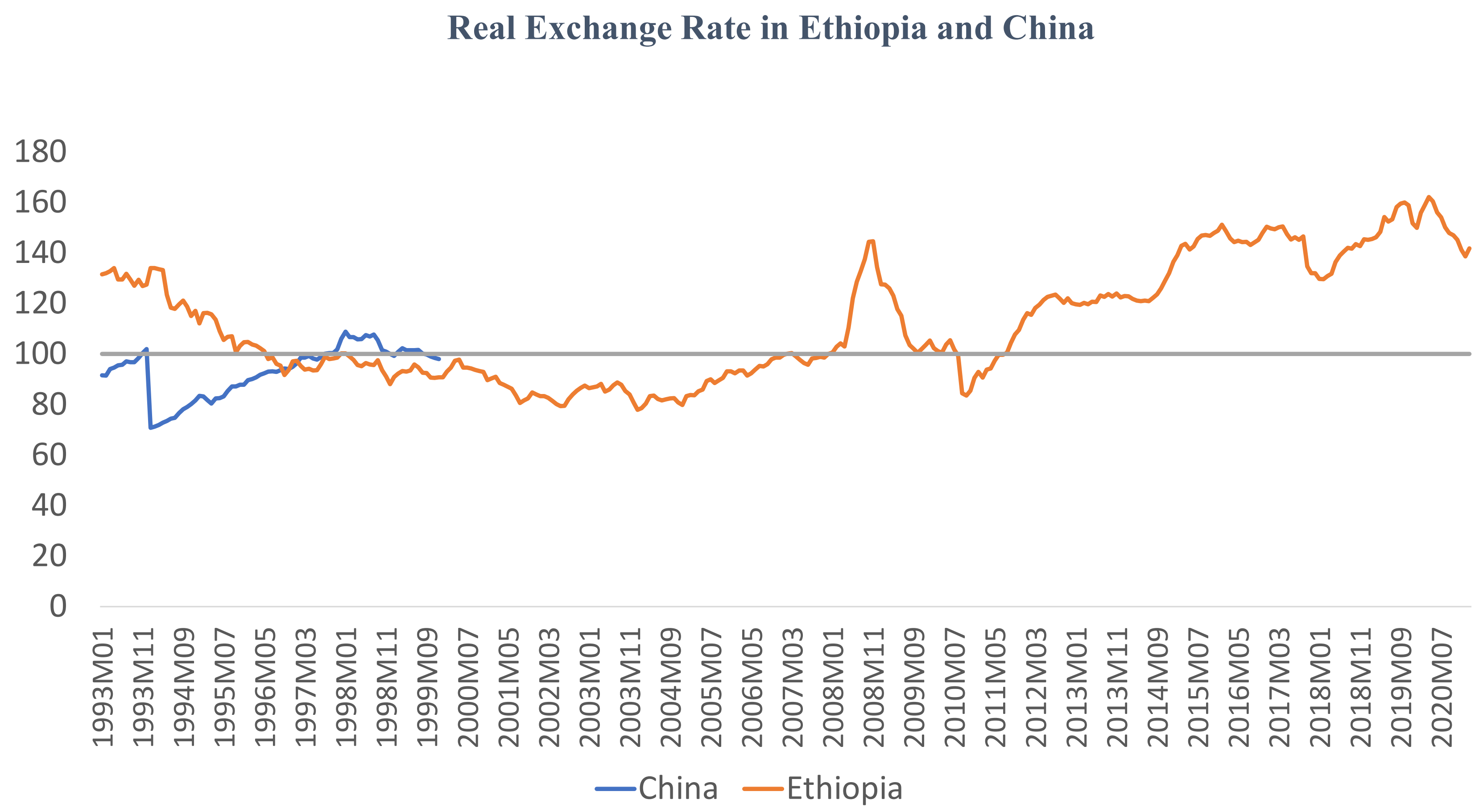
- The average and volatility of Inflation was lower in China. Inflation in China is much lower if we use GDP deflator.

- This indicates external competitiveness of the goods China produces

- Inflation in Ethiopia (CPI): average=12.3%, standard deviation=11.5%
- Inflation in Ethiopia (GDP deflator): average=11.7%, standard deviation=9.6%

- Inflation in China(CPI): average=9.4%, standard deviation=8%
- Inflation in China (GDP deflator): average=6.4%, standard deviation=5.6%

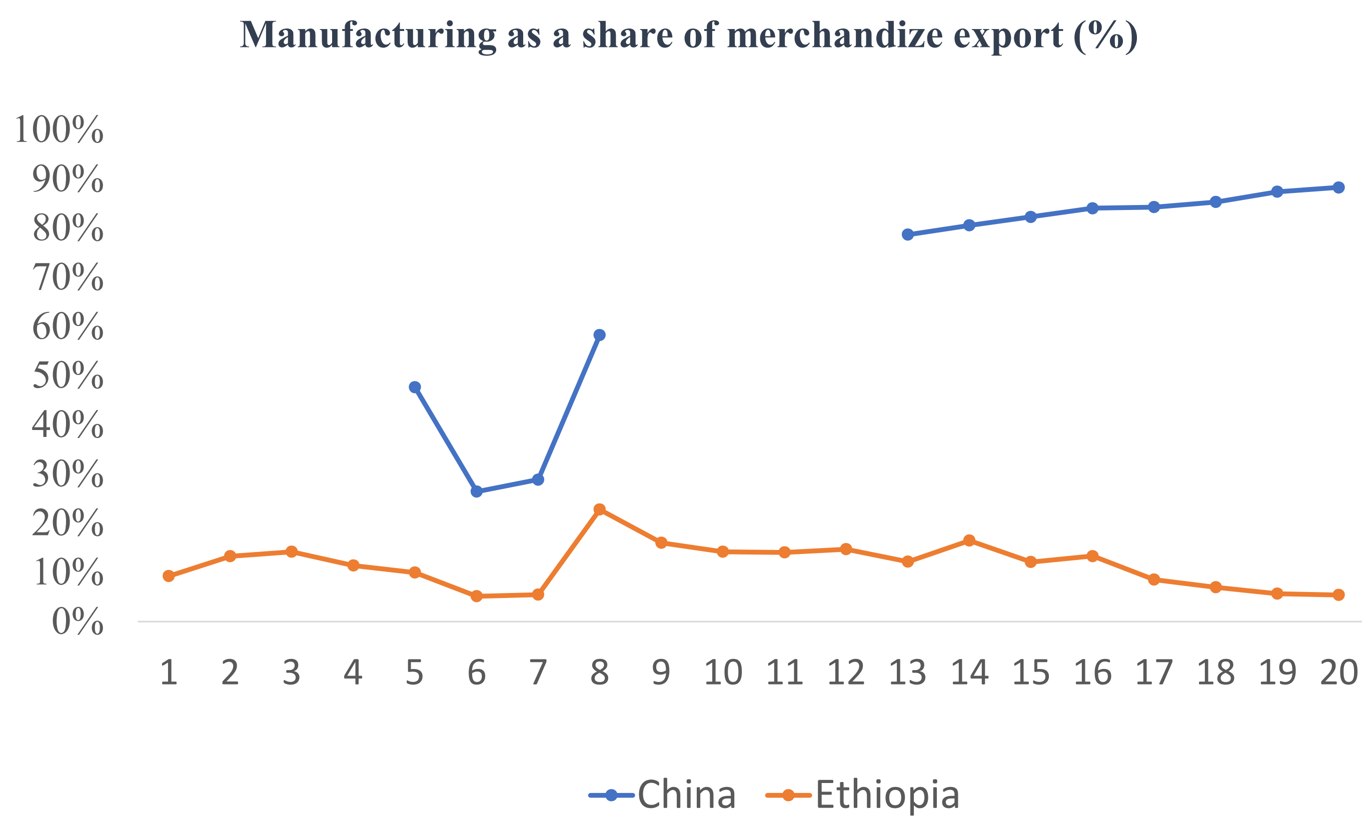
Uncompetitive Real Exchange Rate in Ethiopia



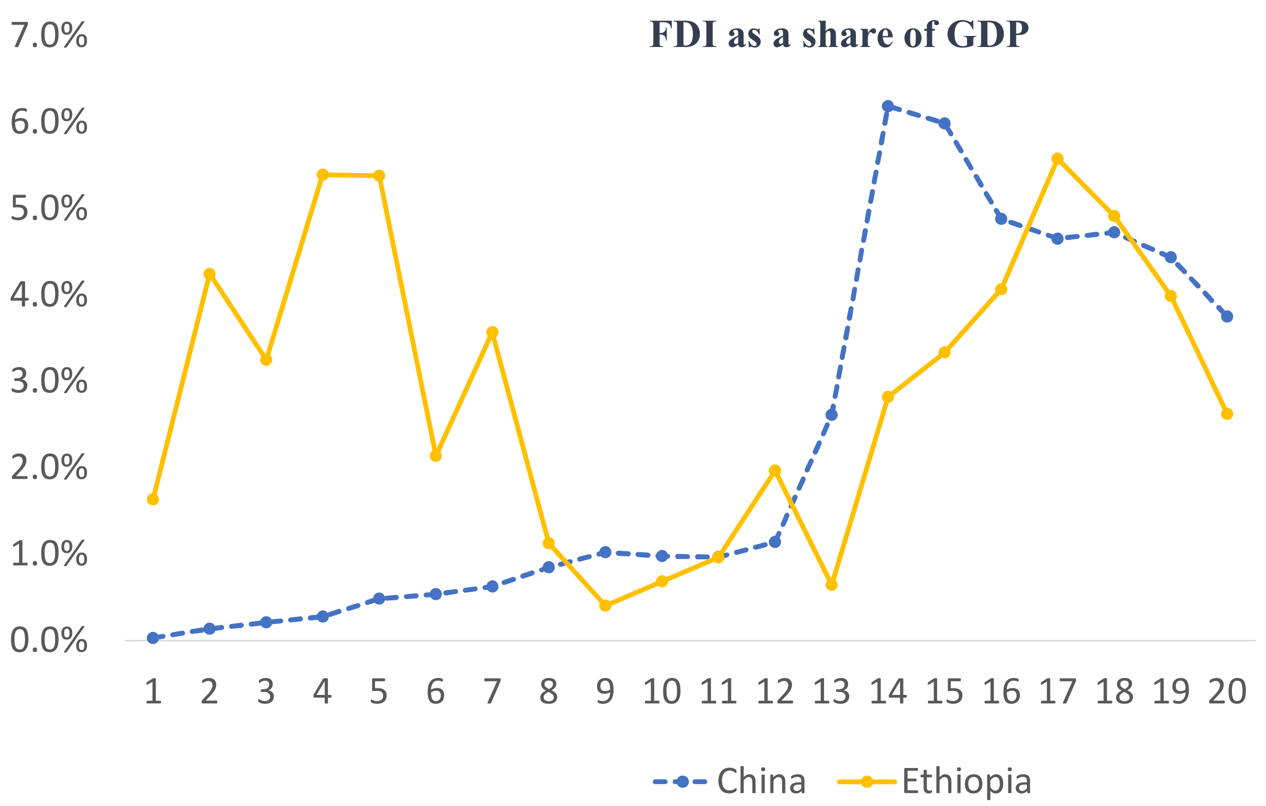
Uncompetitive Real Exchange Rate in Ethiopia

- In Ethiopia, real exchange rate was depreciating in much of the 1990s.
- However, in the comparison period, inflation was much higher due to demand push factors
- And the monetary authorities did not adjust the crawling rate of the peg to reflect the change in inflation rate.
- As a result, real exchange rate was appreciating consistently since 2003.
- China, on other hand, followed an undervaluation of the currency as an industrial policy

Partly due to overvaluation, export of manufactured goods in Ethiopia underperforms



Volatile FDI in Ethiopia



Volatile FDI in Ethiopia

- One reason for the underperformance of manufacturing sector in Ethiopia both in general and in export may be due to lack of local capabilities.

- One way to overcome this hurdle is to learn from FDI firms

- The country implemented several polices to entice FDI firms. That has attracted significant FDI at the beginning. But FDI is lagging in recent years.

- Note that the recent decline in FDI as a share of GDP in Ethiopia is in the face of declining economic growth.

Part II: Policy Lessons

The situation in Ethiopia: What can be learned from China?

- The situation in Ethiopia:
  - Volatile inflation
  - Uncompetitive real exchange rate (overvaluation),
  - Lagging FDI and Manufacturing, and
  - Reliance on debt financing characterize the Ethiopian economy over the last two decades.

- Are there potential lessons the country can learn from China 's macro-financial policy ?

Monetary policy in Ethiopia

- In Ethiopia, there is fiscal dominance of monetary policy in the country. i.e., Legally, NBE is required to meet the government's requests for credits and advances each year.

- NBE conducts monetary policy by setting broad money (M2) growth to be in line with the growth of nominal GDP. The Bank operationalizes its policy through targeting the growth of reserve money.

Monetary policy in Ethiopia

- **Two critical aspects:**
  - A) The monetary policy regime hinges on the existence of a stable "money multiplier“
  - B) and stable velocity of money.

- However, there is no stable relationship between M2 and nominal GDP. And there is no stable relationship between M2 and M0 (the policy instrument).

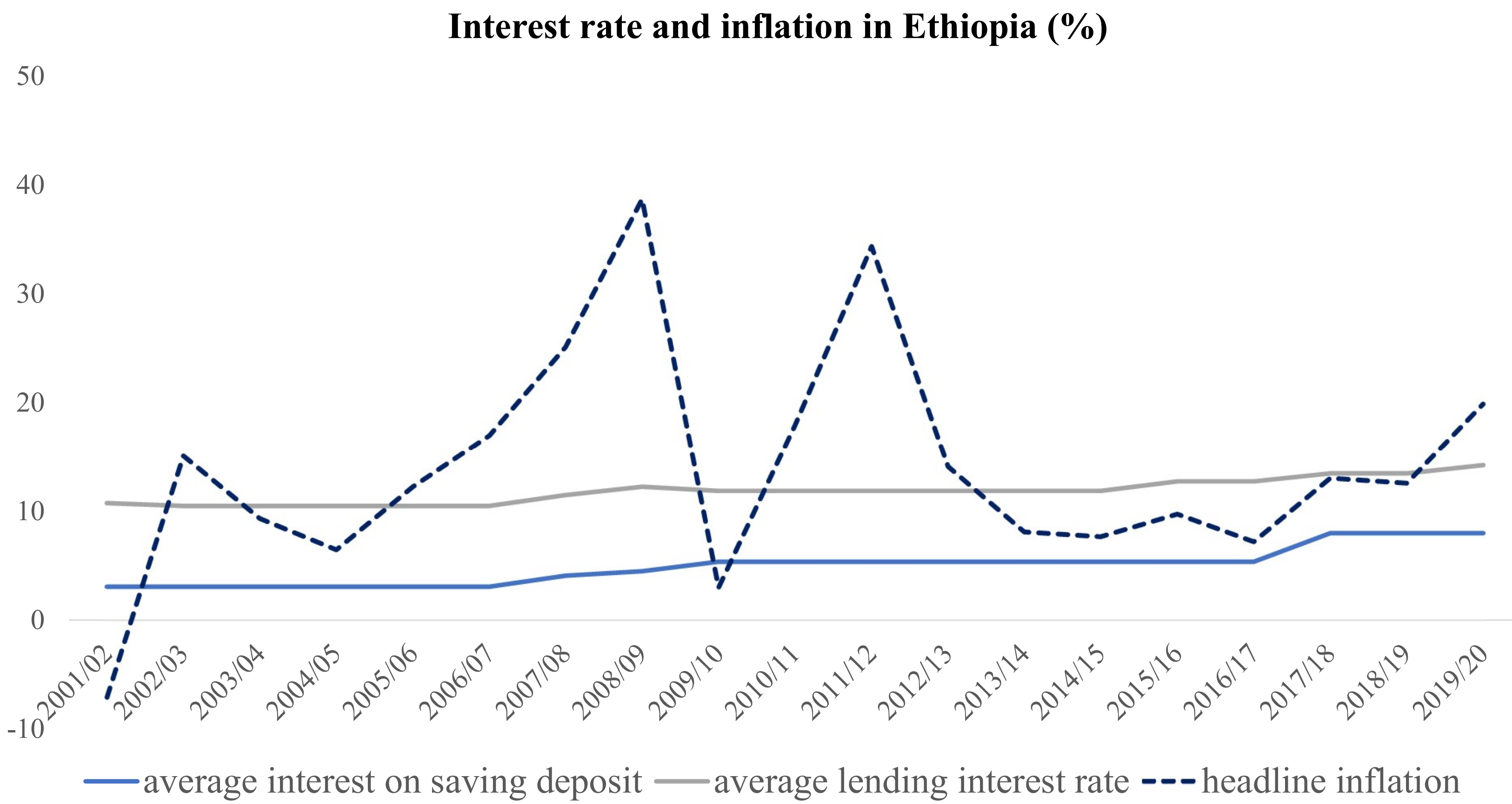
- Also, any demand or supply shock that doesn’t come from monetary policy is accommodated

Monetary policy should be proactive: Lesson from China

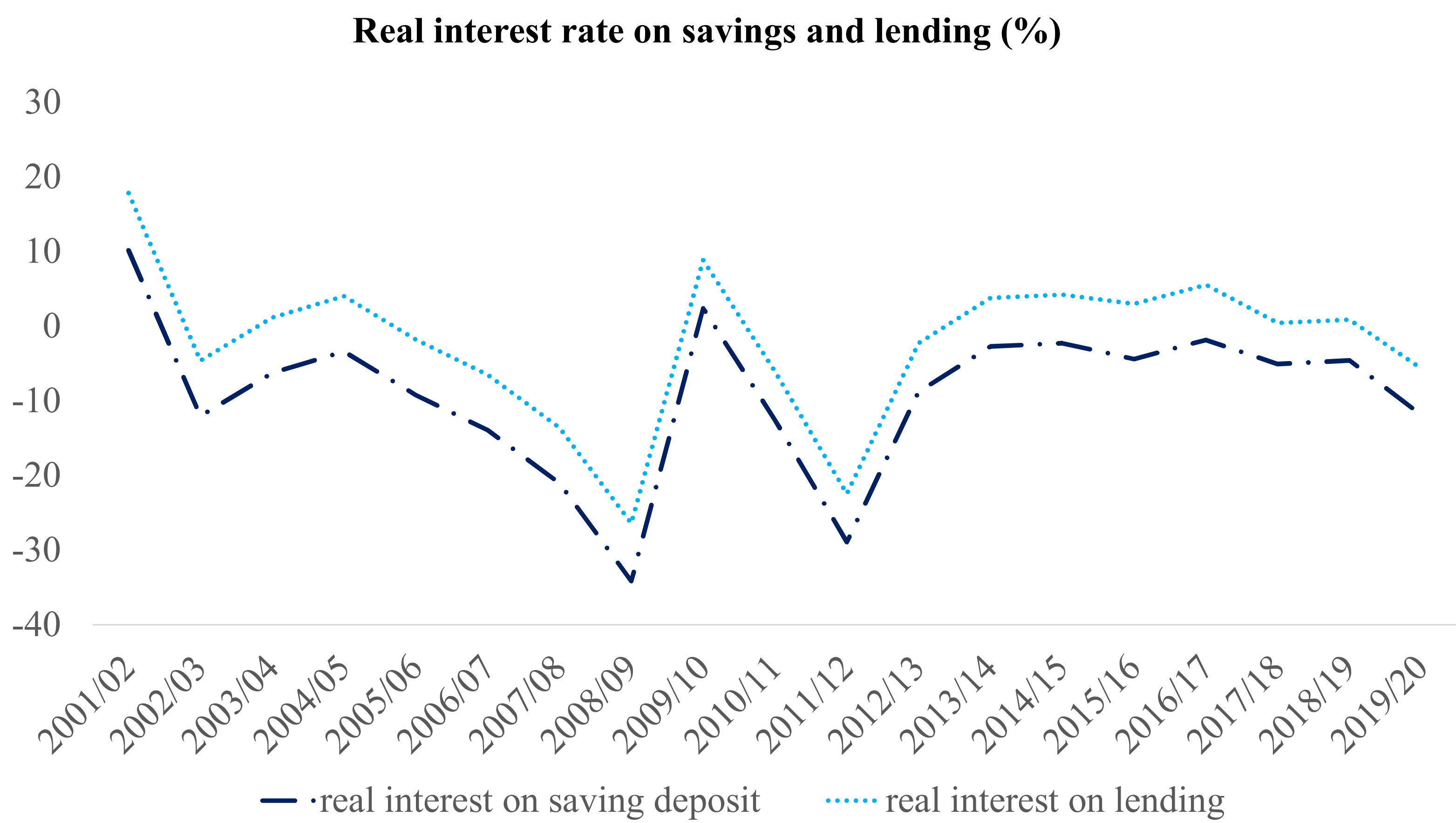
- In China, fiscal and monetary policy collaborate to bring about price and growth stability.
- In terms of monetary policy, the government changes policy instruments such as the saving and deposit rate and required reserve ratio to influence the investment behavior of firms and the saving and consumption behavior of households.
- In Ethiopia, monetary policy accommodates the aggregate demand push of the government. In other words, unlike in China, price stability is given low attention.

- **Proactive monetary policy, supported by fiscal policy, is a lesson for achieving price stability**

Monetary Policy and Investment



Monetary Policy and Investment



Monetary policy and Investment

- In Ethiopia, significant financial repression to enable public investment

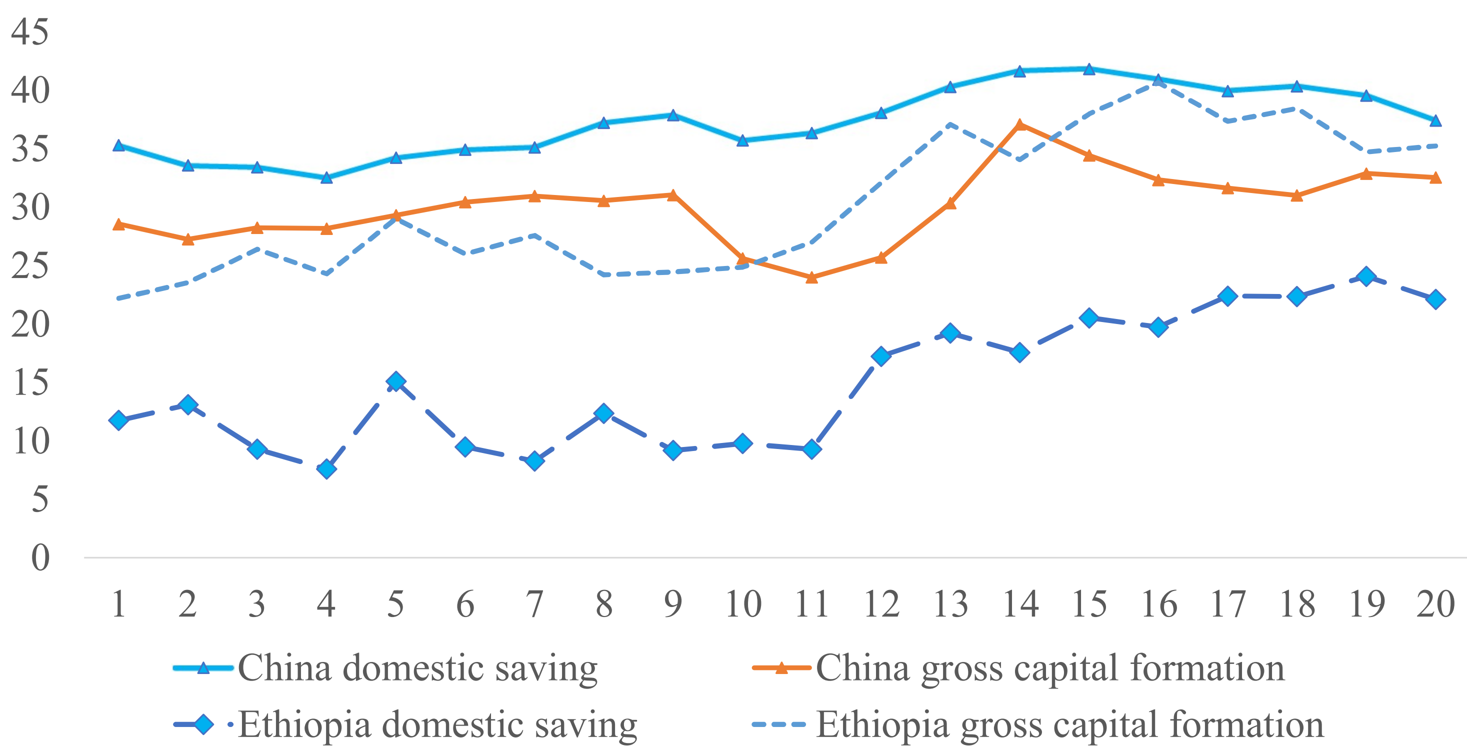
- Real interest on saving is negative. Average real interest rate on saving deposit in the 2003-19 period is (-10%).

- Although there is some primary capital market, there is no secondary market. Lack of liquidity (i.e., exit strategy) means many do not invest on the stock market.

- **Although, the low interest rate encourages investment, domestic saving as a share of GDP is very low.**

Monetary policy and Investment

Gross capital formation and gross domestic saving as a share of GDP in China and Ethiopia (%)



Monetary policy and Investment: Lesson from China

- Ethiopia and China had similar investment as a share of GDP in their comparatively similar growth periods
- Both also followed financial repression as a strategy
- However, the repression in Ethiopia (-10% real interest rate) goes further than China's (zero real interest rate on average)
- Ethiopia's gross domestic saving was not enough to finance investment. Therefore, foreign borrowing as a major source of financing investment

- **Lesson: keeping some level of incentive for savers is an important ingredient of a monetary policy conducive for investment.**

Foreign Exchange Management: Lesson

- Both countries correct their respective currencies' overvaluation when they shift away from a command-and-control economic system.

- However, during the comparison period, Ethiopia’s real exchange rate keeps appreciating while China’s was depreciating.

- As a result, at the end of the comparison period, China was able to shift to managed floating arrangement.

- In Ethiopia, overvalued exchange rate with large parallel market premium. Difficult to transit to managed floating arrangement.

Foreign Exchange Management: Lesson

- In addition, China gradually increased the incentive for exporters to keep their forex earnings or sell at a competitive rate.

- In Ethiopia, the incentive for exporters is actually decreasing over time

- **Lesson: Keeping a competitive exchange rate is a crucial policy**

Foreign Exchange Management

The trend in official and Parallel exchange rate of the Birr against the USD