

## **PART ONE** **Sustaining Growth: Ethiopessimism?**

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*by Ken Ohashi*  
*World Bank's Country Director for Ethiopia and Sudan*

The international community in Addis seems to have suddenly turned pessimistic about the prospects for Ethiopian economy. Inflation, which was troublingly high at 19% in January, has by June jumped to 55% (measured as the 12-month increase in the overall Consumer Price Index). Ethiopia's foreign exchange reserves are running low, making it more difficult for domestic investors to secure foreign currencies needed to import key materials and equipment. Though much better now, load shedding had affected daily life in many areas last several months. Above all, however, the food crisis and images of children in acute malnutrition are enough to make anyone not just saddened but gloomy about the future. Was the five years of rapid economic growth all so fragile? Was it only a result of good weather and a 'rebound' from the 2002/03 drought?



Not so long ago, many of the same people were optimistic that Ethiopia would sustain fast growth and quickly overcome abject poverty and recurrent famines. This optimism was shared by many Ethiopians overseas, who were busy making real estate and other investments back home. Even a feeling of a boom economy was emerging.

I do not wish to minimize the terrible suffering of those in hunger, or those who struggle with rising food prices. Nevertheless, I also believe this swing in outlook is unwarranted. If the past optimism was euphoric, the current "Ethiopessimism" is equally excessive. Over the last several years, Ethiopian economy has become much stronger, but it also faces complex new challenges today.

In the first of a two-part series of articles, I will focus on the developments in the recent years and argue why the past achievements are more durable than the skeptics believe. In the second article, I will discuss the emerging economic risks and possible ways to address them.

How has the economy changed?

First, physical infrastructure has improved.

- **Roads:** Paved Federal roads, which form the main transport arteries, have increased from 3,800 km in 2000 to nearly 5,500 km by 2007, an increase of 43%. Including the expansion of other Federal and Regional roads (to 37,000 km) and the explosion of *woreda* and community roads, the total road length has tripled to 100,200 km. Extension of roads means improved access to market and more economic opportunities for everyone.
- **Power:** Since 2000, power generation capacity has nearly doubled to 791 MW today. It will rise to 1,970 MW within the next 18 months. The percentage of households with direct access to electricity has increased from 5% to 8%, and is expected to reach 15% by 2010. These are still modest figures, but the percentage of population living in areas with access to electricity has increased from 13% to 22%, and should reach about 50% by 2010. This 'indirect' coverage at least gives people benefits of many services that are impossible without electricity. Electricity brings more advanced technology.

Second, agriculture, which still generates 40-45% of GDP, is undergoing some changes, and there is now a base to sustain significant increases in productivity. The spread of new technology has been slow thus far. At only 36 kg per ha of cultivated land, average fertilizer use remains very low by international standards. In certain areas, however, use of fertilizer has increased sharply. The evidence suggests some farmers are

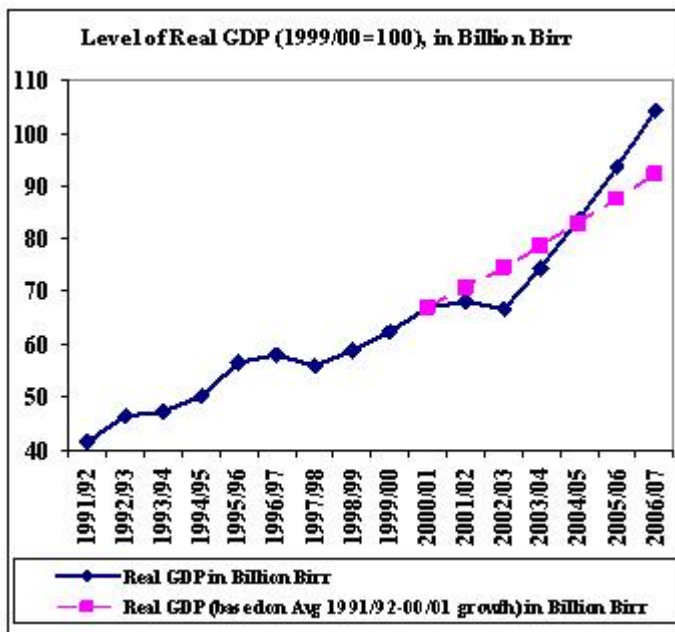
successfully adopting new technologies. The key is to scale it up. In this regard, the deployment of Development Agents (extension workers) is important as the interface between farmers and new technologies. From about 15,000 in 2000, the number of DAs has risen to about 67,000 now. That is a significant institutional capability. Land certification programs have also improved land use security for many farmers, with tangible increases in investment.

Third, Ethiopia has become more investor friendly. For instance, whereas the Investment Climate Survey of 2001 reported a number of serious obstacles, such as access to land, tax administration, finance, etc., the new survey in 2006 found there had been significant improvement in all key areas. In the Doing Business 2008 rating, Ethiopia is ranked ninth by African firms in terms of the overall business environment. Targeted Government support to strategic industries (flowers, leather products, and textiles) has been quite effective.

Finally, the education and health status of the work force has been rising, supported by dramatic improvement in basic service delivery. For instance, from 1999 to 2006, primary school enrollment has increased from 5.2 million to 14 million. Of course, the impact on the overall labor force is only gradual; still, between 1999 and 2005, the percentage of employed urban workers with a minimum of 5 years of education has risen from 52.7% to 56.1%. A more educated work force is more productive.

Turning to the actual growth record, my contention is that Ethiopian economy is now capable of delivering much higher growth than in the 1990s, and that the recent strong growth is not just good luck. 1991/02 was the worst year in Ethiopia's modern economic history. The per capita income level was about 30% below the previous peak in 1971/72. It is not easy to estimate the potential growth rate of a quickly changing economy, but if we compare 1991/92 and 2000/01, I think we get a pretty good estimate for those years. In the early part of that 10-year span, Ethiopian economy enjoyed a rebound from the disastrous economic performance of the Derg period (1974-1991). Later, Ethiopia suffered from a war, with GDP contracting by 3.7% in 1997/98. These exceptional factors are likely to offset each other to a large extent. Thus the average of 5.5% seems to be a reasonable estimate of the potential growth rate, a rate intuitively consistent with the kind of economy Ethiopia was in the 1990s, with improving economic policies but a modest infrastructure base.

If you assume Ethiopian economy after the 2002/03 drought was similar in its potential growth capacity, then you would expect GDP to move back to the 5.5% trend line shown in the following chart. Actually the economic output was 12% higher than the "potential" by 2006/07. It is hard to argue this is primarily a rebound, which is based on underutilized production capacity and pent-up demand. It is more natural to think that the trend rate had changed. The average growth rate from 2000/01 to 2006/07 turns out to be about 7.7%. I think this is a much better estimate of the growth potential today.



Still this does not explain why Ethiopia has suddenly run into a multitude of economic difficulties? One way to think of it is that Ethiopia suffers from its own economic successes.

Rapid economic growth can be a double-edged sword. Its intrinsic benefits are obvious. Economic damage done during the Derg period was so severe that only in the last few years Ethiopian per capita incomes have surpassed the previous high of the early 1970s. Yet, Ethiopia remains one of the poorest countries in the world. Therefore, it desperately needs to grow in order to lift its citizens out of poverty.

Rapid growth, however, can also expose serious structural weaknesses in an economy, making such growth ultimately difficult to sustain. This is the challenge Ethiopia faces today. Aggressive public sector-led investment programs resulted in sharp increases in demand for both investment and consumption goods. But, without deeper structural reforms, the expected private investment—both domestic and foreign—did not materialize on a scale to keep pace with the demand growth. This imbalance between demand and supply is at the core of the rising trade deficit as well as inflation. The trade deficit has ballooned to an estimated \$4.7 billion equivalent in FY2007/08, about 22% of GDP. Of course, the global rise in oil and other commodity prices has made it worse. But, the inflation in Ethiopia has been much higher than in most other African countries. I have little doubt that this is to an important degree caused by the domestic demand-supply imbalance.

Does this mean Ethiopian economy now needs to slow down sharply, at least to the recent trend rate of around 7.7%, and perhaps to an even lower rate temporarily to restore the basic balances? Or are there ways to preserve relatively high growth while dealing with the twin imbalances, i.e., inflation and external deficits? I believe there are things the Government can do to avoid a costly shock therapy.

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## **PART TWO**

### **Sustaining Growth: A Way Forward**

***By Ken Ohashi***  
***World Bank's Country Director for Ethiopia and Sudan***

Setting aside the food crisis for a moment, Ethiopia's two main economic challenges today are rampant inflation and rising trade deficits. They are interrelated. They reflect an economy that is trying to grow faster than the supply side could keep up. When domestic demand grows faster than domestic supply, an underlying inflationary tendency is created, and imports rise sharply to alleviate domestic shortages. Of course, the external shocks of high oil and other commodity prices and the failure of Belg rains earlier this year have exacerbated the problem.



Behind all this is the growth strategy of the Government of Ethiopia (GoE). It aims to create quickly a strong infrastructure base and certain key production capacity (e.g., in hydropower, cement, and export industries in general) so that in time, growth of imports will moderate and exports will begin to narrow the trade deficit. This is a risky approach, for it is an attempt to "over invest" in certain things in anticipation of a strong supply response. But, Ethiopian policymakers argue that a gradualist approach will not do in a country that has been mired in severe poverty for decades. The current food crisis, which was caused by a failure of rains that generally contribute no more than 10% of the annual food supply, is a stark reminder that Ethiopia needs fast and sustained

growth to overcome such vulnerability. Having managed to get the unprecedented growth started—an impressive feat in itself—GoE leaders are keen to sustain this at all cost. Until a tipping point in external imbalance arrives, they hope that more aid and remittances may bridge the financing gap.

Is this a credible scenario? Should the donors step up aid efforts to help fill the temporary financing gap? I believe this strategy has certain coherence. But, the recent experience has also revealed an important weakness. Private investment, while very strong in select sectors, has not responded to the increasing opportunities on the scale needed to keep the supply side of the economy growing fast enough. Various analyses indicate that investors still find the 'business climate' in Ethiopia not good enough for a major investment rush that could have avoided this supply problem. One should also not forget that after a 17-year Derg regime, Ethiopia's private sector started from a very weak base in the early 1990s.

This does not mean the basic strategy is wrong. I think it can still be viable, and I hope it will prove successful. I believe, however, some mid-course corrections may be necessary. To give a more considered answer, we will have to examine carefully the possible export and import trajectories, underlying investment projections, etc. But, I have some tentative suggestions.

First, I do not think Ethiopia can count on increased aid and remittances alone to offset the rising trade deficits for the next several years. The gap is simply too large. An important part of the solution is likely to be found in increasing foreign direct investment (FDI), while moderating investment by the public sector. Both types of investments require imports, but FDI brings its own foreign financing. This switch will allow Ethiopia to maintain high levels of investment without causing foreign exchange problems. Of course, this assumes some public investment projects can be delayed without harming growth, or can even be replaced by private investment. Ethiopia may find such substitution opportunities in electricity generation, transportation, etc. If state-owned enterprises are involved in conventional manufacturing activities, they would offer obvious opportunities for FDI substitution.

Second, there is still much Ethiopia can do to encourage private sector investment broadly and increase the supply response to the growth in demand. Studies have identified several areas of action, including access to finance, access to land, etc. Measures that encourage FDI are usually also good for domestic investors (unless they are preferential measures). Since Ethiopia faces a shortage of foreign exchange, focusing on areas that can attract FDI may be timely. One idea I found interesting is the possibility of opening the domestic civil aviation sector to foreign/domestic joint ventures, and lifting the limit on the size of aircraft private companies can operate. This can bring not only foreign investment but also increase Ethiopia's attractiveness to foreign tourists. Furthermore, it would increase the passenger traffic for Ethiopian Airlines from its international routes, a major foreign exchange earner for the country. Although I do not know all the complexities of this industry, this seems like an attractive proposition. I imagine there are many other such ideas. If foreign investors are required to enter Ethiopia through joint ventures, then it would also help promote domestic businesses.

Third, agricultural productivity remains too low. This is true despite the significant growth in output and some impressive success stories (e.g., roses). I had indicated in part one that an important foundation has been laid to accelerate productivity growth. There is now a need for a comprehensive program to make it happen on a large scale. Although there is an important role for public investments, e.g., in rural infrastructure and research and development, this needs to be complemented by a policy environment that leads to significantly higher levels of investments by entrepreneurial farmers and the agribusiness sector alike. One way to achieve this is through active promotion of public-private partnerships. For example, a strong cooperation between public agricultural research on the one side and private seed companies and farmers on the other can facilitate market access and availability of high-yielding varieties to farmers.

Fourth, it is essential to tackle inflation. High inflation tends to stifle savings and investment in productive assets, favoring holding of inflation-resistant assets (such as buildings, undeveloped land, or even *teff*). This does not help growth. Inflation in Ethiopia already points to some of these problems. East Asian countries that sustained rapid growth for many years all kept inflation in check and encouraged domestic savings and investment. I cannot think of any easy solution for Ethiopia's inflation, for it seems to be now driven significantly by expectations. GoE has already done much to contain growth of money supply. Whether this, combined with good harvest this fall, will be enough to reverse the inflationary expectations is yet to be seen. All I can suggest is GoE needs to remain vigilant and perhaps be prepared to take tougher actions as needed (possibly including further slowing of public investments).

These challenges are daunting. It is important, however, to remember that these policy problems arose from too much growth, not lack thereof. Many governments would gladly exchange their headaches of slow growth for GoE's headaches. Although increased donor assistance is unlikely to be big enough to solve the

problem of foreign exchange, I do believe that when combined with policy measures to increase supply responsiveness of the economy, additional aid could be very helpful in facilitating a smoother transition to a more sustainable growth path. Without such help, the acute foreign exchange shortage could force Ethiopian economy to slow down abruptly. That would be a huge setback for poverty reduction and a costly way to adjust to macro imbalances.

In part one of this piece, I had indicated that the potential growth rate of Ethiopia may have risen to around 7.5-8% in recent years. Ethiopia should not be satisfied with maintaining that trend line. With strong policy measures to increase supply responsiveness and manage inflation, I believe that rate has the potential to head toward 10%. Poverty reduction in Ethiopia needs that kind of growth. That would make Ethiopia's growth strategy truly bold, and well worthy of strong donor support.