ETHIOPIA'S PRIVATE SECTOR UNDER STRUCTURAL ADJUSTMENT: RESPONSE TO FOREIGN TRADE LIBERALIZATION AND EXCHANGE RATE POLICY REFORM

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1. INTRODUCTION AND OVERVIEW

After the end of the civil war, Ethiopia embarked on a comprehensive program of reform aimed at, inter alia, opening up the economy and providing an environment for facilitating international trade and investment. The liberalization measures reflected the realization that an improved exchange and trade regime are essential to promote an efficient allocation of resources and to enhance the external competitiveness of the economy.

The structural and policy changes are, however, very recent. The devaluation of the Birr and some trade reform took place earlier in the fiscal year in October 1992. Introduction of the auction system came in April 1993 and tariff reforms were not finalized in the fiscal year under review. However, substantial liberalization measures have been taken in a relatively short period of time with significant implications for the Ethiopian Economy. There are now some indicators to show that some reorientation in the incentive structure of the economy is taking place with the removal of major distortions and that there is a clear reversal of the recent declining trend in exports. The economy's productive base is being improved as a result of the improved access of the private sector to foreign exchange and inputs. This paper attempts to review these issues.

Section I discusses Ethiopia's trade and exchange regime prior to the policy changes and the initial economic conditions that led to the programme. Section II describes the various policy measures and reforms taken to date and affecting the exchange and trade regime. Section III attempts to assess the impact of these reforms on the country's economic structure and performance. In particular the focus will be on the response of the private sector to the reforms. The final section, section IV, attempts to draw some conclusions.

2. THE EXCHANGE AND TRADE REGIME AND ECONOMIC CONDITIONS PRIOR TO THE ECONOMIC REFORM PROGRAMME

The initial economic and social conditions in the country, prior to the undertaking of the structural adjustment programme, were similar to those in many less developed countries(IMF, 1993) that were forced to undertake similar programmes. Income per capita at US$120 per head in 1991 was the lowest in the world. The growth rate of population of 3% was high. Agriculture accounted for about half of GDP. Export concentrated in a few agricultural importer had to furnish own foreign exchange and pay higher customs duties. Private sector participation was thus restricted in almost all sectors of economic activity where large public ownership accounts for the bulk of domestic consumption of goods and services.

Import substitution and restrictions in trade and foreign investment were a major part of the pre-reform development strategy. High tariffs and a broad ranging import licensing system on competing imports were put in place to encourage domestic production and self sufficiency.

As a result of the protective system, the overall incentive structure favoured production for the domestic market. The average rate of effective protection for the home market was high and the range of effective protection rates wide. The use of direct import control and licensing was extensive and although some direct incentives to exports were provided, there was a distinct bias against exports. Thus, in the period leading to the reform programme the external competitiveness of the country deteriorated.

Foreign direct investment was discouraged and thus played an insignificant role. The regulatory framework clearly discriminated against such investment and the macro-economic environment tended to be hostile and added to the problems.

In the period leading to the institution of the economic reform programme, therefore, the adverse effects of the restrictive trade and investment policies became clear. Trade and exchange restrictions limited trade flows and severely distorted the relationship between international and domestic prices, more generally the incentive structure was biased towards production for the home market. The import substitution policy promoted and protected an industrial sector that was generally inefficient and therefore unable to compete in international markets. Resources allocation remained significantly distorted.

A new development strategy was clearly called for to reorient foreign trade and investment policies to correct distortions and generate increased foreign exchange flows. In particular, private participation in all sectors needed to be encouraged through the rapid removal of barriers to entry, improvements in incentives combined with a loosening of production and trade controls and measures to ease the availability of inputs and foreign exchange.

3. EXCHANGE AND TRADE POLICY CHANGES UNDER THE ECONOMIC REFORM PROGRAMME

Following the publishing in November 1991 of the government's economic policy statement,(TGE, 1991) a three year Policy Framework Paper (PFP) was developed and agreed with the IMF and the World Bank in October 1992. The PFP, which forms the basis for the economic reform programme, sought to revitalize the economy and create a more market macro-economic environment should go a long way towards meeting this objective. Since real wages are low, sustained and credible reforms particularly to the exchange and trade system potentially could attract greater foreign investment.

The exchange and trade liberalization programme is part of the comprehensive policy reform programme. Thus, it will be difficult to isolate the response of the private sector to these measures. Moreover, the measures were spread out over the last year further rendering difficult any concrete analysis of their impact. Given these limitations we now turn to an analysis of the impact of the reforms.

4. IMPLICATIONS OF THE EXCHANGE AND TRADE REFORMS FOR PRIVATE SECTOR DEVELOPMENT

This section will attempt to assess the impact of the reform measures on the private sector and the latter's response. Such an attempt would of course require a lot of detailed information and would be facilitated further by the application of a model of the economy in which the effects of all other reform measures will also be taken into account. Since the time period that has elapsed after the adaption of the structural adjustment programme measures is short (only one year), such treatment of the topic will be seriously constrained. Moreover, the data base, especially with regards to private sector activity, is weak.

Thus, an attempt will be made to approach it through the use of simple indicators and qualitative treatment to indicate the direction of the likely effects of the actions. A before and after approach to performance evaluation will be applied to selected indicators of private sector performance such as changes in output, capacity utilization, investment activity etc. in critical sectors to assess their effects. The focus will be on a comparison of the initial conditions that necessitated the adjustment measures with performance in key areas of private sector activity.

4.1 Impact on Macro-economic Performance

The comprehensive economic reform programme and the liberalization of the exchange and trade regimes are believed to have helped in reorienting the system of incentives and restructuring of the country's productive base to result in reversal of recent declines in overall growth rates. Table 1 below shows major indicators of overall performance.

Most indicators of economic performance improved during the year of programme implementation: real GDP growth which declined by an average of 3.2% in the last three years increased by nearly 8%. Average export volume growth increased by 114% compared with an average decline of 25.6% in the 3 years prior to adjustment. Official reserves rose markedly to 8 weeks of imports. Average inflation fell by half to 10%. The average current account deficit narrowed. The resurgence in economic activity is believed to have come from are carried by the private sector. In industry it is engaged mainly in small-scale and handicrafts enterprises producing around 25 percent of the total industrial value added.

Altogether, the private sector is estimated to account for around 65 percent of GDP. Since the policy environments were not conducive in the last years there has been reluctance on the part of the private sector to be engaged in productive enterprise development. Most of the private capital has been circulating in trade and speculative activities.

The previous policy environment not only hindered the participation of domestic private capital in productive enterprise, it had also failed to attract foreign capital.

Apart from policy constraints, shortage of raw materials, foreign exchange, spareparts, electric power, housing and lack of marketing know-how have contributed to the lagging growth of the private enterprises.

Although these constraints still remain and responses to policy changes inevitably take time to emerge, the role of the private sector in the resurgence of economic activity is evident, at least in the aggregate data.

5. IMPACT ON MAJOR ECONOMIC SECTORS AGRICULTURAL PRODUCTION AND EXPORT

Agriculture is the mainstay of the economy contributing some 46% of GDP, 85% of employment and 85% of export receipts. Private small holder farmers produce most of the food crops as well as coffee.

The production of coffee is estimated to have reached 216,000 metric tons in 1991/92 (Cf190,000 tons in 1987/88). The volume of coffee exports reached 84,022 in 1988/89 but has been declining since. This has been mainly due to the failure of ICO to agree on quotas in mid 1989. At the same time, however there has been an increase in smuggling due to price differentials and the overvaluation of the Birr so that coffee which accounts for over 60% of exports by value declined to 50%.

To restore incentives to the coffee grower, producer prices were increased in 1989. Reduction in the coffee surtax and direct budget subsidy were used to finance the increase. At the same time to liberalize trade and promote the private sector, the monopoly power of ECMC in export was reduced, and private exporters were allowed to compete with it in the auction market. The number of private participants in the auction increased from 13 in 1989 to 24 in 1991 and to 20% of total coffee exports. Moreover, the number of shippers and primary collectors in the coffee sector increased from 131 to 150 and from 1,105 to 1,420 hectares of coffee land under cooperatives have been reallocated to individual farmers. In spite of these efforts, however, the

In Percent

Month	Average of last three years			1992/93		
	ECMC	Private	Total	ECMC	Private	Total
July	77.91	22.09	100.00	71.18	28.82	100.00
August	77.85	22.15	100.00	73.60	26.40	100.00
Sept.	89.55	10.45	100.00	89.58	10.42	100.00
Oct.	93.66	6.34	100.00	72.92	27.08	100.00
Nov.	94.05	5.95	100.00	76.53	23.47	100.00
Dec.	84.84	15.16	100.00	56.71	43.29	100.00
Jan.	78.83	21.17	100.00	65.84	34.16	100.00
Feb.	81.62	18.38	100.00	79.64	29.36	100.00
March	86.03	13.97	100.00	84.80	15.20	100.00
April	87.37	12.63	100.00	75.76	24.24	100.00
May	79.18	20.82	100.00	79.85	20.15	100.00
June	78.91	21.09	100.00	84.81	15.19	100.00
	84.08	15.92	100.00	77.01	22.99	100.00

Source: Ministry of State Farms, Coffee and Tea Development.

Table 3

Coffee Arrival to Central Coffee Markets(In Tons)

Month	1990	1991	1992	1993	Change in %		
					(93/90)	(93/91)	(93/91)
October	4091	3193	2182	3573	87	112	164
November	7908	7113	3609	5052	64	71	140
December	9556	10001	4499	6043	63	60	134
January	9674	11043	6181	8380	87	76	136
February	10224	15403	9592	12202	119	79	127
March	13475	13335	7445	13834	103	104	186
April	13716	9111	8143	12032	88	132	148
May	8996	3578	8786	10049	112	281	114
June	5642	283	5002	10608	188	-	212
Total	61727	52753	45149	67105	109	127	140

Source: Ministry of State Farms, Coffee and Tea Development.

also allowed to establish share companies with limited liability as well as proprietorships and partnerships. Licensing procedures were also improved.

This resulted in dramatic increases in licenses issued. Between May and December 1990, for example, 2609 applications were received in Addis Ababa alone out of which 1867 were approved and involved capital of Birr 475 million and expected to create 28,000 jobs compared to 340 licenses in the previous fiscal year(IMF, Ethiopia, 1991). Nevertheless, the major problems facing the private manufacturing sector persisted in the period leading to the undertaking of the structural adjustment programme in October 1992. These included shortage of raw materials and spare parts, both local and imported and shortage of foreign exchange so that performance has been far from satisfactory. Various policy measures contained in the structural adjustment programme, including those affecting the exchange and trade regime, sought to change this.

Although data on private sector activity remain sketchy, there are signs that recovery is getting underway. For example because of the emergency recovery programme and the flow of donor support imports are beginning to recover. The import of some critical inputs are gradually reactivating dormant production capacity. In the public manufacturing sector capacity utilization are known to have reached 89% from their average low levels of 20-40%(MOPED, 1993). Although figures for capacity utilization in the private sector are lacking, successive availability of foreign exchange both through direct allocation by the NBE and through ERRP, and through the auction system can be expected to have had such an effect.

In fact increased private sector activity was evident as reflected in its response to the allocations. Table 4 shows that Birr 277 million was directly allocated by the NBE for private imports and around Birr 615 million under the ERRP. This compares with the meager annual allocations of less than Br. 40 million before the programme.

Table 4

Private Sector Foreign Exchange Utilization in Million of Birr

	Budgeted	Utilized	ERRP
1990/91	17.6	13.1	-
1991/92	63.3	39.6	-
1992/93	337.2	276.7	615.0

Moreover, since the introduction of the foreign exchange auction system in April 1993 increased, foreign exchange is being made available to the private sector. Table 5 shows that out of a total allocations of Br. 429.2 million during the last 12 auctions, the share of the private

In the past the private sector's requirements have been met through Franco Valuta imports, which have been growing as a result of increased inflow of unrequitable public transfers, and the tightening of foreign exchange control and the existence of a large negative list of goods considered non-essential. Excluding public transfers (which reflect imports by the government and NGOs) most imports that cannot be covered by directly obtaining foreign exchange from the NBE officially were imported by the private sector. This is to say that Franco Valuta imports by the private sector has been a direct response to the prevailing foreign exchange scarcity and the concomitant restrictions on trade and foreign exchange allocation.

As Table 6 below shows, the trend in Franco Valuta imports since the structural adjustment programme, is indicative of the impact of the trade and foreign exchange allocation liberalizations on private sector import activity. It is clear from the table that although Franco Valuta imports in the programme year has grown compared with the previous three years, the share of the private sector declined. Moreover, the decline was more marked since October 1993 showing the effect of the liberalization in trade and foreign exchange allocation to the private sector.

Table 6

The Franco Valuta Import Share of the Private and Other Sectors October-June 1991, 1992 and 1993

Month	1991			1992			1993		
	Pvt.	Public Sector	Total	Pvt.	Public Sector	Total	Pvt.	Public Sector	Total
Oct.	30.2	69.8	100				24.6	76.0	100
Nov.	29.3	70.7	100				21.3	78.7	100
Dec.	29.5	70.5	100				32.4	67.6	100
Jan.	24.2	75.8	100	20.1	79.9	100	26.0	74.0	100
Feb.	30.1	69.9	100	26.5	73.5	100	26.7	73.3	100
March	21.1	78.9	100	29.6	70.4	100	36.8	63.2	100
April	21.4	78.6	100	43.2	56.8	100	17.0	83.0	100
May	12.7	87.3	100	45.5	54.5	100	21.0	79.0	100
June	10.1	89.9	100	44.1	55.9	100	17.7	82.3	100

Source: NBE, Exchange Control Department.

been acute shortage of transport services. Investment in the sector was discouraged and foreign exchange allocation to the private sector for vehicles or spare parts was very low.

The liberalization of the centralized transport system is one of the initial measures taken under the structural adjustment programme. The measures included the decontrol of transport and road tariffs. Data constraints limit a complete assessment of the impact of the deregulation measures in transport. Preliminary indications suggest an increased investment in transport vehicles and equipment, that may have increased the supply of fleet. The increased availability of foreign exchange to the sector both under the ERRP and the NBE is also believed to have resulted in increased private sector activity in transport.

6. CONCLUSIONS

It would be very difficult, and too early, to give firm conclusions on the response of the private sector to the exchange and trade reform measures under the structural adjustment programme. Moreover, the data base on private sector activity in the different economic sectors is very weak.

Nevertheless, the outcome of the first year of the programme, based on the sketchy evidence available, indicates a marked reversal in the initial conditions that had led to the structural adjustment prgoramme. Stabilization has been attained. Overall economic growth has improved, recent declines in exports have been reversed, and some diversification of the export base has taken place. Agricultural production and agricultural exports have increased, and private sector activity in industry, trade and transport has improved considerably. All due to the removal of major distortions, and reorientation in the incentive structure of the economy in favour of the tradeable goods and private sectors. The economy's productive base is surely being improved as a result of the expanded access of the private sector to foreign exchange and inputs.

Too much should not be read into this, however. The long run positive response of the private sector to the measures depends on the simultaneous undertaking of measures to remove structural and other rigidities that continue to inhibit quick private sector response to price signals. For example, in spite of government commitment to privatization under the structural adjustment programme, its implementation has lagged. Likewise ownership rights remain unclear, and bankruptcy procedures are not in place. Financial institutions need to be adapted to handle transactions typical of market oriented economic systems.

Reforms in these areas should go a long way to boost private sector confidence and response. However, as experiences in other countries have shown, and is being observed in this country, these tend to be difficult and controversial and hence subject to delays. It is not surprising therefore, that supply responses by the private sector will be slow to emerge.