THE IMPACT OF MONETARY CONTROL AND FISCAL CONTRACTION ON PRIVATE SECTOR DEVELOPMENT IN ETHIOPIA'S STABILIZATION AND ADJUSTMENT PROGRAM

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1. INTRODUCTION

Ethiopia is among the countries that experienced dramatic derailment of their economy from the use of market forces in resource mobilization and allocation. This was the result of 17 odd years of the totalitarian military government, which was involved in a process of dismantling the embryonic markets forces socialist economy. Consequently, the thrust of policy measures was to rapidly expand the public sector and make it the leading sector in the economy. This was attained, first by giving priority to public enterprises in administrative allocation of resources (foreign exchange, bank credit, land, labour, etc.); and; second, by statutorily declaring state monopoly for investment and production in various sectors of the economy, including for example finance and distribution.

More specifically monetary and fiscal policies were fully geared towards supporting the centrally planned economy with financial institutions serving principally to meet the demand for credit by the central government and the public enterprise sector. Monetary control was exercised directly, with bank credit allocated to accommodate plan targets. Interest rates and other market related instruments played a limited role as transmission mechanisms for monetary policy. The private sector had been virtually denied access to credit. This is because the government and public enterprises had been given first claim on financial resources that were used mostly for unproductive purposes. This led to a build up of monetary overhang and had exacerbating pressures on prices and the exchange rate and had also weakened the financial sector. Higher inflation also led the private sector to be involved mostly in speculative activities rather than productive ones.

In order to address these and other economic problems, the TGE adopted, a three year structural adjustment program supported by SAF in October 1992,, that included among other things, monetary and fiscal restraint and better allocation of bank resources (by releasing funds to the private sector). Thus it aimed at significantly increasing the share of credit to the private sector in total domestic credit in the program period. It also committed the government to ensure positive interest rate structure and the elimination of rate discrimination by ownership or by sector. These policies are, indeed, moves in the right direction for the countries future private sector led growth.

If interest rates are controlled and there is non-monetary domestic borrowing there is a one-to-one negative correspondence between higher credit to the public sector to finance the fiscal deficit and reduced credit for the private sector. Non-monetary domestic borrowing could however be consistent with the macro-economic objectives of promoting private investment by avoiding an increase in the share of public borrowing in domestic credit provided by the banking system. If instead the government increases expenditures and resorts to financing it through money creation, the story is a little more complicated. Financing through additional money creation leads to a rise in the rate of inflation. Since nominal interest rates are fixed, real interest rates fall. If private savings fall, as a result of lower real interest rates, the availability of loanable funds to the private sector declines even further. The credit squeeze on the private sector is to that extent greater. Irrespective of the financing option chosen, a higher fiscal deficit with repressed financial markets will lead to a reduction in credit to the private sector.

When interest rates are market determined, the effects are somewhat different. If the financing is done through non-monetary domestic borrowing, interest rates rise. If higher interest rates lead to more private savings, the extent of the increase in interest rates is contained to some extent. One guideline to avoid rise in interest rates is to target public domestic borrowing at a level consistent with the designed level of domestic real interest rates. Recourse to borrowing through money creation instead of domestic borrowing, with uncontrolled interest rates raises both the rate of inflation and the real interest rate. The real interest rate rises because printing money to finance a deficit can result in inflation to the extent that it exceeds the growth in demand for money at the current level of prices. Higher reserve requirements are one way to avoid that result, but they widen the spread between deposit and loan rates, and can therefore be inconsistent with the objectives of efficiency in domestic financial markets and greater private investment.

Several empirical studies have been conducted, regarding the above mentioned relationship between real interest rates, credit allocation and private investment. The outcome of the empirical survey is that costs of credit and quantity affect private investment in developing countries. However, their relative importance varies, depending on the degree of financial liberalization. In economies with repressed financial systems it is the quantity of credit that affects private investment, whereas in economies where financial markets have been deregulated the real lending rate is the relevant variable.

There was also empirical evidence which shows that, countries, such as Korea, Indonesia, Colombia and Thailand, which kept fiscal deficits in check and curtailed the flow of credit to the public sector and to public enterprises did not get into difficulties and were able to provide positive and uninterrupted flow of credit to the private sector which was crucial in maintaining private investment and growth,. On the other hand in the so called crisis countries there were negative net flows of credit from the financial system to the private sector.

financial sector's role in enhancing the generation and allocation of domestic savings in addition to adequate monetary control instruments. Such measures include: the development of money markets, stream-lining of selective credit controls, development of term finance and capital markets and creation of new financial institutions and instruments.

3. REVIEW OF FISCAL AND MONETARY POLICIES IN PRE SAP PERIOD AND ASSESSMENT OF THE IMPACT IT HAD ON PRIVATE SECTOR DEVELOPMENT

3.1 Review of Fiscal and Monetary Policies in Pre SAP Period

In the 17 years of the totalitarian Derg regime, the problems identified in monetary and fiscal policy areas included.

i) **An expansionary Monetary Policy, fueled in part by the financing requirement of the budget and public enterprises.**

ii) **Fixed exchange rate and rigid exchange rate policy**

The Ethiopian balance of payments experienced strains in 1980s. Technically chronic deficit on the current account of BOP reflects some misalignment of the exchange rate, which has to be responded to by timely depreciation. In other words, exchange rate overvaluation undermines the competitiveness of the trade sector (and hence the drive to increase production in that sector), while at the same time encouraging consumption of imports.

The overvaluation of the exchange rate led to the phenomena of foreign exchange scarcity that was manifested in shortage of imported production inputs and consumer goods. Foreign exchange scarcity was circumvented by tightening of exchange controls and rationing of the scarce input and channelling it to the public sector and thus discouraging the involvement of the private sector in economic activity.

iii) **Directing large amount of loanable funds to inefficient Public Sector**

Monetary policy was geared towards directing the loanable funds that were available with the banking system to the development of the public sector. Due to poor capitalization, the parastatals tended to rely heavily on the banking system for working capital: Under the financial planning regime, which was in practice, credit policy envisaged eventual centralized planning and allocation. Its basic objectives was to expedite the process of socialization of the economy by giving priority to the socialized sector. Thus private firms' access to bank credit had been restricted, because government and public enterprises have been given first claim on financial resources.

f) The lions share of the welfare expenditure were allocated to programs that were show cases and were therefore not sustainable.

g) Emphasis was given to the size of the capital budget rather than to its efficient allocation.

3.2 Quantitative Assessment of Fiscal and Monetary Policies in Pre SAP Period

In the decade to 1990/91, public sector involvement in the economy had increased substantially through the creation of public enterprises, the liberal provision of government guaranteed loans at subsidized rates and large expansion in government deficit.

Table 1 and 2 indicate the quantitative dimensions of fiscal and monetary policies in the Pre-SAP period. Table 1 shows the government budget management indicators and Table 2 shows monetary developments as it is reflected in the accounts of the domestic banking system.

Table 1
Indicators of Fiscal Performance Before Structural Adjustment Program

(in Percent of GDP)

	1983/84	1984/85	1985/86	1986/87	1987/88	1988/89	1989/90	1990/91	1991/92
1. Total Revenue and Grants	25.5	29.9	27.3	28.0	34.6	37.8	28.6	23.3	18.9
1.1 Total Revenue	22.9	23.5	24.6	25.7	29.3	31.4	24.9	19.8	15.6
2. Expenditure	31.7	39.3	34.3	35.8	41.5	46.6	45.5	36.9	29.8
2.1 Current Expenditure	22.4	27.3	21.2	22.5	29.2	31.0	34.3	28.0	23.0
2.2 Capital Expenditure	9.3	12.0	13.1	13.3	12.3	15.6	11.2	8.9	6.7
3. Overall Deficit including grants	-6.2	-9.4	-7.1	-7.8	-6.9	-8.8	-16.5	-13.0	-10.3
3.1 Domestic Bank Financing	3.4	4.8	2.0	4.4	2.8	3.4	10.2	8.9	8.3

Table 3
Commercial Bank Lending By Borrower
(Shares as % of Total Credit)

	1987/88	1988/89	1989/90	1990/91	1991/92	1992/93
1. Central Government	53.2	59.2	65.2	70.2	67.2	51.1
2. Public Enterprises	29.4	27.9	23.2	18.9	21.6	27.3
3. Financial Institutions	0.6	0.5	0.5	0.4	0.4	1.9
4. Cooperatives	0.7	0.7	0.4	0.3	0.6	0.6
5. Private Sector	16.1	11.6	10.7	10.2	10.2	19.1

Source: Commercial Bank of Ethiopia

The above view can also be supported by the analysis of inter-sectoral financial flows in the years from 1989/90 to 1991/92, which is demonstrated in a financial flow matrix in Table 4. The matrix describes the financing of the various sectors of the economy. The columns indicate sources of funds and the rows indicate uses of funds. For example cell C1 shows other banks claims on government.

From Table 4 the following government and private sector net borrowing from the banking system can be identified.

Exhibit 2: Government and Private Sector Net Borrowing

Increases in net borrowing by:	1989/90	1990/91	1191/92
- Central Government	1140.5	1018.4	987.8
- Private Sector & Public Enterp.	-295.6	87.5	-165.8

Source: Table 4

This shows that there was a large volume of net lending both by NBE and CBE to Central Government, whereas net borrowing by the private and public enterprises sector decreased in 1989/90 and 1991/92. It should however be noted that lending by the banking system to Central Government did not crowd out the private sector, since CBE had excess liquidity recently. The main purpose of this analysis is to indicate the discriminatory practices against the private sector

which resulted in shortages ofinvestment opportunities that gave rise to "forced saving". These forced savings were used to finance the budget deficit. the government thus enjoyed cheap financing from private savings in the banking system. This is due to the previous governments socialist paradigm of development, which made it difficult for private holders of liquid assets to convert them into investment, because investment activities in real state, manufacturing and services industries had been tightly regulated and subject to fixed asset ceiling and case-by-case licensing. The main commercial outlet for private investment had thus been trade, but even here opportunities had narrowed as the number of traders' licenses had been reduced. Converting liquid assets into expenditure on durable consumer goods had been restrained by restrictions on the imports of these goods.

It should however be noted that the forced savings of the private sector that helped to finance the budget deficit indeed helped to contain the inflationary impact .of aggregate liquidity expansion. But, such deficit financing is evidently unsustainable for the future private-sector-led growth, where the private sector is expected to mobilize its idle balances and borrow from the banks in order to finance its business expansion.

4. REVIEW OF FISCAL AND MONETARY POLICY REFORMS INTRODUCED UNDER SAP AND THEIR IMPACT ON PRIVATE SECTOR DEVELOPMENT

4.1 Review of Fiscal and Monetary Policy Reform Introduced Under SAP

In October 1, 1992, the Transitional Government of Ethiopia concluded a Structural Adjustment Program agreement with IMF for the period 1992/93 - 1994/95. The thrust of this reform program was to create a framework for the private sector to be the driving force behind production, while limiting the role of government in the economy to the function of policy formulating and regulating. However, the government would maintain a leading role in the provision of social and physical infrastructures. The elements of the reform program can be categorized under three main areas. First, achieving macro-economic stabilization aimed at narrowing fiscal imbalances to ensure price stability, and adjustment in exchange rate to achieve a viable and sustainable external balance. Second, introducing reforms in the areas of pricing, taxation, and trade policy aimed at improving incentives for production and exports. Third, developing a regulatory framework, which makes it possible for the private sector to engage in most aspects of economic activity.

The reforms envisaged in the areas of fiscal and monetary policies are discussed below.

behind the imposition of ceilings on credit to Central Government and public sector entities was to avoid the crowding out of the private sector.

The other monetary policy instrument that was adjusted was nominal Interest rates. Throughout the period till October 1992 nominal interest rates were prescribed administratively by NBE. During this period financial repression was in place with all its attendant adverse consequences on savings mobilization and efficiency of financial resource utilization.

Following the adoption of the IMF/World Bank supported SAP in October 1992, interest rate policy was made active and the thrust was to attain positive interest rates in order to encourage savings mobilization and their deployment. The adjustment made on interest rates made them positive in real terms. By the end of 1993/94, with the possible elimination of the monopoly structure of the commercial banking sector, administered interest rate structure is envisaged to be eliminated, with only minimum deposit and maximum lending rates set. From 1995/96 on ward, with the development of the banking system, the rates will be market determined. The eventual use of indirect instruments of monetary control will be fostered by increased sales of government bonds and bills to the public.

4.2 Assessment of Indicators of Fiscal Performance and quantitative Bench Marks for 1992/93

In the following an attempt is made to evaluate the actual performance in fiscal and monetary area by comparing achievements versus targets and developments in the latest year of the Pre-program period. This is summarized in Table 5.

Fiscal Performance

The overall revenue performance was below the level envisaged in the program. This may be due to some structural measures, including rationalization of income and profit taxes, elimination of non-coffee export taxes and the elimination of capital charges on most public enterprises. In the sphere of customs, the maximum duty rate has also been reduced from 230 percent to 80 percent.

On the recurrent expenditure side, there was also a short fall as compared to the program which was 27.8% of GDP. This reflected short falls in grants which was 5.5 percent of GDP as compared to the programmed amount of 11.5%. It should also be noted that in 1992/93, most budgetary subsidies were eliminated, although some payments due from the preceding year continued to be made. The TGE has made great effort to limit the pace of current expenditure by requiring public enterprises to absorb the cost of the recent wage adjustment. The estimated capital expenditure was 12.7 percent of GDP as compared to the programmed amount of 15.9 percent of GDP. Capital expenditure, particularly from donor financed projects is considerably below the program target, reflecting a slow implementation rate.

domestic financing, which was one of the main objectives of the program and is crucial for private sector led growth.

Performance as related to Quantitative Bench-Marks and their Impact on Private sector Development

Quantitative ceilings for credit to central government and non-central government for 1992/93 were established in the program. The main purpose of this is the achievement of balance of payment objectives and the avoidance of the crowding out of private sector capital formation by the government. The ceilings therefore help in cutting back government fiscal deficits and release resources to the private sector.

In the 9 months period after structural adjustment program, the above mentioned improvement in fiscal balance allowed for the substantial materialization of the monetary program targets by the end of 1992/93 (See Table 5). Broad money grew by 16.2% as against the programmed 19.2% and 13.3% in 1991/92. Domestic credit has increased by 18.8% as compared to 22.8 percent in the program and 13.0% for the 1991/92 fiscal year. Growth in credit to the government in 1992/93 was 11.2% as compared to 14.0% in the program and 16.8% in 1991/92. The growth in credit to private and public sector was programmed to grow by 42.7%, but rose by 35.7%. This is in comparison to a small growth of 6.2% in the preceding fiscal year.

Break down of the aggregate credit disbursed by CBE by sector and ownership (see table 6) indicates that there was a significant rise of credit to private sector during 1992/93 in reversal of declining trends in the pre structural adjustment period. Credit disbursement to the private sector was particularly sharp for industry, domestic trade and imports. Credit disbursed for private industrial enterprises increased from Br 16.2 million in 1990/1991 to Br 87.4 million in 1992/93. Credit disbursement to privately owned domestic trade grew from Br 85.5 million in 1990/91 to Br 321.2 million in 1992/93. Credit disbursed to privately owned imports also rose from Br 7.0 million in 1990/91 to Br 57.0 million 1992/93.

These higher credit disbursements to the private sector are the result of the structural adjustment program which created an enabling environment for the private sector in terms of: elimination of discriminatory credit and foreign trade treatment, simplification of procedures for licensing and the encouragement of private sector participation in all sectors of economic activities.

5. CONCLUDING REMARKS

In the 17 years of the Derg Regime the Ethiopian economy was saddled with heavy distortions and controls that limited productivity by directing most resources to the public sector and denying access to bank finance and investment opportunities to the private sector. This sector was therefore forced to use part of its resources for speculative activities or leave funds in the banking system.

The TGE, having recognized that, the weaknesses of these policies hampered efficient mobilization and allocation of resources; and has undertaken structural adjustment program, the major immediate purpose of which was to bring about macro-economic stability and to significantly increase the private firms' access to bank resources.

The aim of this paper was to give quantitative picture of the impact of fiscal and monetary dimensions of the on-going structural adjustment program on private sector development. The analysis clearly indicated that relatively very great improvement in releasing financial resources to the private sector was achieved within such a very short span of the adjustment period. This is a clear indication that the adjustment program is already on the right track and will evidently provide a strong base for much stronger fiscal and monetary adjustment in the coming years to attain sustained macro-economic stability and highly desired private sector led growth.

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