

# Ethiopia's Trade and Investment: Policy Priorities for the New Government

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September 2010

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## Abstract

As Ethiopia's new government begins work in September 2010, it is armed with a new plan: the *Growth and Transformation Plan (GTP)*. Trade and foreign direct investment (FDI) figure in the new plan but less reliance is placed on FDI inflows than in the past and as much emphasis appears to be placed on import substitution as on export expansion to reduce the trade deficit. Ethiopia has tried different trade strategies in the past, the perennial goal being to diversify its exports to reduce dependence on coffee and other cash crops. Nonetheless, Ethiopia has a low share of trade in GDP, its exports continue to have limited diversification, and its trade deficit has widened significantly. This paper argues that Ethiopia's trade performance has been held back by a combination of factors that are amenable to policy treatment, including very high trade costs due to poor trade logistics and burdensome official requirements, an unsupportive macroeconomic policy mix, and private sector under-development that is at least partially attributable to weaknesses in the microeconomic framework. By the same token, it argues that targeted infrastructure and regional cooperation developments, in conjunction with a trade-friendly macroeconomic policy and domestic administrative reforms would, properly sequenced, enable Ethiopia to use its abundant factor of production—cheap labour—to drive its development on a basis less vulnerable to the risks inherent in rain-based agricultural production, including participation in processing trade. On this basis, it identifies a set of priority initiatives for the new government.

**Keywords:** Ethiopia, trade policy, liberalization, trade costs, facilitation

**JEL Codes:** F13, F14, F15

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## 1. Introduction

As Ethiopia's new government begins work in September 2010, it faces the usual panoply of challenges endemic in developing countries with too few instruments and too few resources, while also grappling with the perennial problem of managing development, namely sequencing of policy reforms, all subject to the political constraints of containing the disruptive impacts of policy reforms to acceptable levels, a particularly important problem for Ethiopia given the very narrow margins for manoeuvre imposed by fiscal and external deficits, subsistence levels of household income for much of the population and a complex ethnic/regional weave in its social fabric. Getting the priorities right and managing change, the central issues addressed by the EMPA Symposium, are thus particularly vital issues for Ethiopian public management.

The new government has a new plan: the *Growth and Transformation Plan (GTP)*, which is to succeed the previous *Plan for Accelerated and Sustained Development to End Poverty*. The new plan is ambitious: it assumes real growth of GDP of a minimum of 11 percent per annum over the period 2010/11 to 2014/15, with a "best case" target of doubling the size of the Ethiopian economy over that period, which would require annual GDP growth of 14.9 percent<sup>1</sup>. By comparison, the International Monetary Fund in its Spring 2010 *World Economic Outlook* estimates Ethiopia's real growth in GDP over the period 2006-2010 at 10.3 percent and projects a growth rate for the period 2011-2015 of 7.6 percent<sup>2</sup>, only half the ambitious target rate.

Trade and foreign direct investment (FDI) figure in the new plan but less reliance is placed on FDI inflows than in the past and as much emphasis appears to be placed on import substitution as on export expansion to reduce the trade deficit. As in the previous plan, agricultural production is the main basis for economic development, with a projected doubling of basic agricultural output over the plan period to meet domestic food requirements, to provide the raw material for industrial development<sup>3</sup>. The sectoral focus of the plan is on sectors that are labour intensive, use agricultural products as inputs, help achieve technology transfer and are either export oriented with significant export potential or import-substituting: leather and leather products; sugar and sugar products; cement; metal and metal works; chemical products; pharmaceuticals; and agro-processing. The plan also emphasizes support for small and medium-sized enterprises in general.

The requirements for expansion of agricultural output may prove to be a tall order given that Ethiopia was able to expand the quantity of agricultural production by only about one-quarter over the most recent five-year period 2004-2009 (FAOSTAT). Moreover, expanded agricultural production depends on intensified use of water resources. Water is scarce in the region and any diversion (particularly of Nile source water) from increased irrigation use will predictably exacerbate the already existing tensions with neighbouring countries.

Given these considerations and reflecting the central role that labour-intensive industrial exports based on processing imported inputs have played in fuelling development elsewhere (e.g., East

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<sup>1</sup> "Economy to Grow by 50pc to 100pc," *AddisFortune*, 22 August 2010.

<sup>2</sup> The growth rates for 2006-2010 and the projection for 2011-2015 are based on the IMF *World Economic Outlook*, April 2010, estimates for Ethiopian GDP at constant prices in national currency.

<sup>3</sup> "Economy to Grow by 50pc to 100pc," *AddisFortune*, 22 August 2010.

Asia), it is legitimate to question whether trade, and trade in non-agricultural products in particular, should rank higher in Ethiopia's development plans.

Ethiopia's track record on using trade for development is not exactly encouraging. Different trade strategies have been used in the past, including import replacement/protection for infant industries during the Imperial period, state-managed trade during the military government era, and a more market-oriented liberalized approach supported by much trade-related technical assistance in the most recent period. Ongoing initiatives include negotiations for accession to the World Trade Organization, with the European Union on an Economic Partnership Agreement discuss and with African regional partners on a Tripartite Free Trade Area (TFTA). The perennial goal of Ethiopia's trade policy has been to diversify its exports to reduce dependence on coffee and other cash crops. Nonetheless, Ethiopia has a low share of trade in GDP, its exports continue to have limited diversification, and its trade deficit has widened significantly, leaving it dependent on financial assistance to pay its import bill.

This paper argues that Ethiopia's trade performance has been held back by a combination of factors that are amenable to policy treatment, including very high trade costs due to poor trade logistics and burdensome official requirements, an unsupportive macroeconomic policy mix, and private sector under-development that is at least partially attributable to weaknesses in the microeconomic framework. By the same token, it argues that targeted infrastructure and regional cooperation developments, in conjunction with a trade-friendly macroeconomic policy and domestic administrative reforms would, properly sequenced, enable Ethiopia to use its abundant factor of production—cheap labour—to drive its development on a basis less vulnerable to the risks inherent in rain-based agricultural production, including participation in processing trade.

The paper is organized as follows. Section 2 briefly reviews the main arguments for choosing a trade-oriented development path and the associated caveats. Section 3 identifies the main factors holding back Ethiopia's trade performance. Section 4 suggests the policy priorities for the new government to address these hindrances, including the issue of sequencing. Section 5 provides some concluding comments bearing on the management of the reform process.

## **2. The role of trade and investment in development**

Economic development is difficult. Eloquent testimony to this effect is provided by the list of "advanced economies" compiled by the International Monetary Fund: it consists of only 33 economies (out of a total of 183 in the dataset), 17 of which are small, with populations of less than 10 million, including four with less than one million. This is a striking fact, given that there are functioning models to emulate, a general consensus concerning the characteristics of economies that have successfully developed, and decades of experience with a wide range of policy prescriptions. The difficulty of actually getting the process to work undoubtedly reflects the fact that development cannot be engineered—it is organic in nature, involving the generation of a complex ecology of different types of firms interacting with suppliers, customers and competitors, developing their own corporate cultures and bodies of firm-specific knowledge, as well as the relatively more straightforward tasks of building infrastructure and institutions. In the end, the economy's output, its production processes, and perhaps most importantly, the jobs and

knowledge base of its workers are transformed. The word “transformation” in the *Growth and Transformation Plan* is thus well chosen. There is an important element of chemistry involved, which sometimes kicks in unexpectedly and sometimes fails to kick in despite best efforts on policy frameworks, hence the inconsistent and puzzling empirical record and the ever-growing list of conditions that need to be fulfilled for any particular policy prescription to work reliably.

The role of trade and foreign investment in this process, and particularly the role of trade and investment policy liberalization, has been much disputed.

As regards trade, simple exchange based on comparative advantage promises efficiency gains but not necessarily a higher rate of growth or anything resembling development. Endogenous growth theory (Romer, 1990) does promise higher growth for more open economies as trade stimulates technological change by increasing returns to innovation and/or by facilitating the absorption of technology developed abroad (e.g., through knowledge spillovers<sup>4</sup>). However, various efforts to confirm a connection between openness and growth (including Sachs and Warner, 1995; Dollar and Kraay, 2002; and Wacziarg and Welch, 2003) were disputed on methodological grounds (Rodriguez and Rodrik, 2001; Easterly, 2005; and Rodriguez, 2007). More recently, Estevadeordal and Taylor (2008) after explicitly addressing the various critiques reached the narrower conclusion that liberalizing tariffs on imported capital and intermediate goods did lead to faster GDP growth, a fairly tepid result. Microeconomic studies based on “new, new trade theory” (Melitz, 2003), which recognizes that firms of varying levels of productivity co-exist in the same industry, routinely confirm that more productive firms self-select in entering export markets; however, the record on whether there is a “learning by exporting” effect, such that participation in foreign markets boosts productivity, is less clear-cut with some studies finding in support of this hypothesis and others finding no evidence (see Wagner, 2007 for a survey). Given these conflicting views, the likely impact of greater trade liberalization on growth in the Ethiopian context must be assessed based on Ethiopia-specific empirical evidence.

The story on FDI is rather similar: attracting foreign investment can provide developing countries direct gains by increasing the level and growth of productivity in the host economy, increasing exports in the case of processing trade, improving the quality and variety of producer services for local firms, and generating resource rents in the case of extractive industries. However, the more interesting benefit from a developmental perspective is spillovers, which can be upstream to suppliers (e.g., in terms of more demanding standards for production inputs), downstream to customers (in the form of improved production inputs) and horizontally in the form of competitive stimulus to local firms (including competition amongst them in vying to become suppliers to the foreign-invested company) and/or diffusion of good practices, even to firms in other industries. However, as with trade, the empirical assessment of the growth and developmental effects of FDI has yielded mixed results. FDI does not necessarily add to domestic investment as it has been found at times to crowd out local investment. Similarly, local firms may experience reduced productivity in the face of competition from the foreign multinational rather than benefitting from knowledge spillovers, which it is in the interest of the foreign-invested firm to prevent (e.g., see Aitken and Harrison, 1999). Overall, Carkovic and

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<sup>4</sup> Paul Romer’s 1990 “Endogenous Technological Change” paper explicitly linked international integration to higher growth. Rivera-Batiz and Romer (1991) emphasized knowledge spillovers internationally through economic integration as a driving force.

Levine (2005), surveying the conflicting evidence and addressing the issue of causality (does FDI generate growth or does it seek out fast-growing countries?) conclude that there is no reliable cross-country evidence that FDI consistently induces higher growth, either through spillovers in the microeconomic studies or through macroeconomic channels. The GTP appears to have placed little, if any, accent on the role of FDI in achieving some of the goals identified. We shall discuss the extent to which this may impact the development outcomes over the plan period.

Trade and investment can clearly accelerate the development process by providing ready access to the technology that is a necessary component of a developed economy and by filling in gaps in both the demand and supply of the spectrum of goods and services that are traded in developed economies but not at earlier stages of development. In other words, through trade and investment, the production structure can adjust towards a modern industrial pattern at a faster pace than the evolution of domestic demand and supply capacities would permit. At the same time, the mixed empirical record and the growing list of conditions that seem to be needed for trade and investment to reliably generate the expected benefits has led to a new caution in policy recommendations, with emphasis on targeting liberalization (e.g., on imports of capital goods and attracting particular types of FDI), on developing supply capacities to take advantage of trade opening and on building linkages to domestic suppliers to maximize the local benefits of inward FDI (e.g., see te Velde, 2010).

The discussion of Ethiopia's trade and investment policy priorities below should be read in light of the above.

### **3. Factors Holding Back Ethiopia's Trade Performance**

Given that Ethiopia has tariff-free access to the world's largest economies, the European Union and the United States, and generally faces lower tariffs in other of its major markets than it applies itself, the major factors that account for the low trade share of GDP and the yawning trade deficit must be considered to lie in its domestic economic framework. Following Ciuriak (2010), the factors that hinder Ethiopia's exports may be enumerated as follows:

- (a) The macroeconomic policy mix: the use of the exchange rate as an external anchor for domestic price stability resulted in a steep rise in the real effective exchange rate through the 2000s, undermining the competitiveness of exports and of import-competing production.
- (b) High trade costs: Ethiopia is one of the most difficult places in the world from which to engage in the global economy, ranking 123rd out of 155 countries in the World Bank's 2010 trade logistics survey<sup>5</sup> and 159th out of 183 countries in terms of trading across borders in the World Bank's 2010 *Doing Business* survey. Contributing factors include:
  - The complexity of the process for exporting and importing (8 documents required in each case, compared to a world minimum of 2 in France).
  - The long time it takes to export and import even standard containers (49 and 45 days respectively).

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<sup>5</sup> See Arvis et al (2010).

- Slow and expensive transportation (road transport rather than rail and lack of seamless multimodal transport systems—most inward and outward bound containers are unstuffed/stuffed in Djibouti).
  - Cumbersome customs procedures (a risk-based approach to customs inspections and international transit agreements to facilitate border crossings have not been implemented, resulting in multiple inspections en route).
  - Several indirect effects of the large trade imbalance and high direct trade costs work to further raise trade costs, including: the number of empty containers leaving Ethiopia, which is factored into the cost of shipping; the high costs of importing add to the cost of production inputs which in turn reduces the competitiveness of exports; and long lead times for import and export are closely associated with heightened uncertainty concerning the exact amount of time that is required to import or export, which can be even more damaging for traders than the time costs themselves.
- (c) Private sector under-development: Ethiopia’s industrial structure is dominated by a relatively small number of government-owned firms and conglomerates, features a high degree of market concentration, and is characterized by relatively high administrative barriers to entry (Ethiopia ranks 93<sup>rd</sup> in the world in ease of starting a business under the World Bank’s *Doing Business* methodology). According to the most recent survey of Ethiopia’s manufacturing sector, there were only 1,930 manufacturers in the country in 2008/09 defined as “large and medium scale” employing 133,673 persons<sup>6</sup>, and 43,338 “small scale” manufacturing establishments, more than half of which are grain mills, employing 138,951 persons<sup>7</sup>. These are very small numbers for a country with a total population in excess of 80 million. Since a significant contribution to trade growth comes from new firms entering export markets with new products, a stunted private sector results in a weak supply response to new market opportunities afforded by trade liberalization or facilitation. Moreover, Ethiopia opened its first industrial park (in Dukem) only in 2009; since industrial districts that promote knowledge “spillovers” across firms are the drivers of industrial development, Ethiopia is off to a late start in developing its industrial culture.<sup>8</sup>
- (d) Producer services: Some of the most sought after services needed to accelerate the efficiency of production in the goods sector, such as finance, telecommunications and transport, are relatively inefficient themselves. Moreover, even though Ethiopia’s services sector has been expanding its share of GDP, there is some anecdotal evidence to suggest that this expansion reflects in part the extraction of rents through high margins, which in turn works to reduce the competitiveness of the underlying industrial sectors. Since only the most profitable firms can engage in export markets, high producer services costs eliminate a swathe of potential industrial goods exporters from export markets.

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<sup>6</sup> Large and medium-scale manufacturers are defined as those that employ 10 or more persons and use power-driven equipment. Source: Central Statistical Agency, Manufacturing Industries Survey, [http://www.csa.gov.et/index.php?option=com\\_content&view=article&id=62&Itemid=489](http://www.csa.gov.et/index.php?option=com_content&view=article&id=62&Itemid=489).

<sup>7</sup> Small scale manufacturers are defined as those with fewer than 10 employees and using power-driven machinery. Source Central Statistical Agency, Ethiopian Small Scale Manufacturing Industries Survey, [http://www.csa.gov.et/index.php?option=com\\_content&view=article&id=92&Itemid=413](http://www.csa.gov.et/index.php?option=com_content&view=article&id=92&Itemid=413)

<sup>8</sup> It is to be noted that the development of the industrial park is still in its infancy stage; it is not likely that any significant level of production will commence before 2011/2012.

- (e) Thick borders: Ethiopia's trade with its immediate neighbours is comparatively low in good measure because of the poor connections to the regional borders and inadequate border infrastructure; ignoring the special cases of Djibouti (for which trade statistics are distorted by inclusion of goods in transit) and Somalia as well as oil imports from Sudan, Ethiopia's two-way trade with its immediate neighbours in 2008 amounted to US\$118 million, little more than one-fifth the amount that would be expected given the size and proximity of these economies.
- (f) High tariffs applied by potential African partners: Ethiopia has good access to global markets due to zero tariffs in the major industrialized countries but still faces significant tariff barriers in its African trading partners, with a simple average of about 9.54% in the countries that are part of the Tripartite Free Trade Area (TFTA) negotiations.

This enumeration of inhibiting factors provides a short list of issues for the new government to address to improve Ethiopia's trade performance. The list is organized in rough order of importance, in that the first three items appear to be more important factors than the latter three. Notably, traditional trade policy issues – tariffs and border measures – are not top of the list. Much of the policy action required to improve Ethiopia's trade performance thus lies in other areas.

#### **4. Trade and Investment Policy Priorities**

The surprise devaluation of the birr on August 31, 2010 from a value of 13.63 to the US dollar to 16.35<sup>9</sup>, which was apparently not taken under duress but rather to boost export performance, represents an important recognition by the Ethiopian government that its policy setting had been a factor in inhibiting Ethiopia's external performance. However, by itself, this move falls short of addressing the problem, which, as outlined above, reflects numerous and complex factors.

In the first instance, given the role that the exchange rate peg had played in promoting domestic price stability, the most recent devaluation, which follows on the heels of a sequence of previous devaluations over the past two years, leaves open the question of the strategy the government will follow to maintain macroeconomic stability while it seeks to boost export performance (see for example some of the discussion surrounding the recent devaluation<sup>10</sup>.)

Moreover, it is not out of the question that the devaluation alone might prove to be disappointing in terms of its impact on trade performance, both in the very short term due to a “J-curve” response whereby the trade balance initially deteriorates as import costs are driven up while the export response is slow to take effect, and even in the medium term depending on the response of imports and exports to the lower cost of Ethiopian goods relative to imports.

Two particular concerns stand out in the latter regard.

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<sup>9</sup> See, National Bank of Ethiopia, Inter-bank Daily Foreign Exchange Rate in USD); at <http://nbebank.com/market/dailyexchange.htm>, accessed, September 21, 2010.

<sup>10</sup> For example, see Arvind Subramanian's blog entry of September 3, 2010, “Ethiopia's Experiment” at <http://blogs.cgdev.org/globaldevelopment/2010/09/ethiopia%E2%80%99s-experiment.php>

First, the Marshall-Lerner condition states that the trade balance will correct if the sum of the import and export demand elasticities is greater than one. In the context of a developing country which is importing goods for which there are no domestic substitutes<sup>11</sup>, and is exporting commodities for which demand tends to be price inelastic, the sum of the trade elasticities may indeed be less than unity.

Further, market structure may work to dampen the impact of the devaluation. Commodities produced by developing countries are often sold into commodity markets dominated by a few major international buyers whose market power enables them to appropriate the rents; because of this market structure, it is quite possible for the devaluation to boost the profits of multinational buyers with little of the benefit trickling down to the Ethiopian producers. By the same token, this would limit the supply response and thus the extent of correction in the external balance. At the same time, given high margins in Ethiopia's distribution system<sup>12</sup>, import price changes due to the devaluation may not be fully passed on by importing wholesalers to final buyers (e.g., if importers seek to maintain volumes on those import items that are price elastic), which would also work to reduce the overall correction in the trade balance.

Further, it is important to take into account the impact of the devaluation on the cost of some of the commodities that are part of the value chain for domestic production and exports. For products that have a high import content in their production inputs, devaluation could adversely impact export competitiveness.

Accordingly, a more comprehensive policy response, sustained over the medium term, is required to redress a situation generated by years of policy settings inimical to good export performance. The following is a suggested package of measures to pursue over the coming years.

(a) *Adjusting the monetary policy mix*

Various instruments are available to central banks to conduct policy as they seek to promote price stability and economic growth. In Ethiopia's case, where price stability, growth and export competitiveness are all concerns, it is useful to consider the issue in terms of the monetary conditions index<sup>13</sup>. This index expresses a given degree of monetary tightness as a weighted average of movements in interest rates and in exchange rates according to their respective estimated effects on aggregate demand. A given degree of monetary restraint chosen to reflect macroeconomic conditions (e.g., restraining inflation or supporting growth) can be achieved with alternative combinations of higher (lower) real interest rates and lower (higher) valuations of the exchange rate.

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<sup>11</sup> In a developing country with a highly skewed income distribution, imports are likely to fall into two broad categories: basic necessities and/or production inputs which would naturally have low price elasticities; and luxury goods which are only purchased by the very wealthy for whom the devaluation would constitute a relatively minor deterrent. For both reasons, overall import demand may be quite price inelastic.

<sup>12</sup> See Access Capital Research (2009) for a discussion of the margins on cement.

<sup>13</sup> For an example of the application of the monetary conditions index to the analysis of macroeconomic imbalances, see *Figure 4.6: Monetary Conditions (MCI)*, in International Monetary Fund, *World Economic Outlook*, October 1998, p. 113. In this case, the analysis addresses the situation facing Japan in the mid-1990s during the period of the very high yen.

In the 2000s, Ethiopia essentially combined a highly expansionary domestic interest rate policy, which in fact resulted in negative real interest rates, with a real appreciation of the birr to try and contain the resulting inflation. This policy mix tends to induce substitution of capital for labour in production and to substitute imports for domestic production while restraining exports and reducing savings. The opposite mix—higher interest rates and a lower exchange rate—induces substitution of labour for capital and domestic production for imports, while encouraging exports and domestic savings.

From Ethiopia's export perspective, the latter mix is preferable; arguably, it is also preferable from other policy perspectives as well since it favours more intensive use of Ethiopia's abundant factor of production, labour, an important consideration as Ethiopia seeks to commercialize its agricultural sector, which in turn raises the issue of finding employment for surplus labour in the rural sector<sup>14</sup>; and it encourages domestic savings, a vital issue for sustaining growth in the longer run.

By establishing the monetary conditions index as part of the basic frame of reference for Ethiopia's monetary policy, the implications for price stability and growth of policy moves such as the recent birr devaluation could be evaluated. This would provide guidance regarding the possible need for complementary adjustments to interest rate policy and/or fiscal policy and, by the same token, would help answer questions that the investor community might have concerning the implications for inflation.

Second, given the international ramifications of using exchange rate policies to address competitiveness issues, it would be highly useful for Ethiopia to establish a benchmark for what might be in some sense a "fair" valuation of the birr. There is no straightforward answer to the question of how to arrive at such a valuation. Given the huge global imbalances and the very wide swings of the real exchange rates of the major currencies against each other, the global exchange rate setting is far from anything that might be considered representative of "equilibrium"; by the same token, it is problematic to speak of equilibrium exchange rates for a non-traded minor currency such as the birr. History is a poor guide since aid flows and allowed higher valuations of the exchange rate than would otherwise be possible, creating a "Dutch disease" effect for the industrial sector. Wide historical swings in the prices of major import and export commodities such as oil and coffee and large growth differentials compared to trading partners during the growth spurt enjoyed by Ethiopia in the last half decade further complicate the analysis of exchange rate valuations based on macroeconomic "fundamentals". Purchasing power parity exchange rates such as those calculated by the World Bank also provide no guidance in Ethiopia's case because of the huge part of the economy that is not functioning at market prices.

One approach which could be used as an interim measure and which has the benefit of simplicity is to use the trade balance in goods excluding the major commodities (oil and coffee) and capital goods (trade in which would be reasonably expected to be in deficit in a country growing as rapidly as Ethiopia) as an indicator of whether trade deficits are benign or reflective of excessive consumption and an anti-export bias in the policy setting.

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<sup>14</sup> It can be noted that the latter mix, as a generalization, reflects the policy mix of the successful Asian economies; the former reflects the less successful policy mix of many Latin American countries.

Armed with these benchmarks and analysis of trade responses to the recent exchange rate changes, Ethiopia would be in a position to choose an appropriate policy mix to advance its growth/inflation targets while also maintaining reasonably competitive conditions for its exporter community and avoiding the large real exchange rate fluctuations observed in the past which have had deleterious effects on the development of Ethiopia's export capability.

Absent such a framework, questions are raised. For example, notwithstanding the devaluation of the birr, interest rates remain low. Since low interest rates imply a low rate of return to capital, mobilization of domestic savings will be problematic. This raises questions as to how to induce greater domestic savings and investment. Given the silence on FDI policy, the logical implication is that government would have to fill the savings/investment gap, which would require greater levels of taxation, to finance the ambitious GTP.

At the same time, it would have a cogent framework in which to articulate its policy moves, not an insignificant benefit given the need to maintain confidence in the investor community. A lingering question surrounding the recent devaluation is how it has affected confidence in the birr. This has implications for expectations of the private sector. In the distributive trades, evidence suggests that firms are marking up prices significantly higher than the nominal percentage of the devaluation. This suggests that the devaluation in part has fuelled some degree of uncertainty among private sector players as they speculate about the possibility of even further devaluations in the months ahead.

*(b) Expanding Ethiopia's industrial supply capacity*

A more competitive exchange rate setting will allow existing exporters to expand export market share (i.e., expand trade at the "intensive margin") while at the same time allowing existing domestic producers competing with imports to expand their domestic market shares. Importantly, it will also permit a range of the more efficient existing non-exporters to begin to export, helping to both expand the volume of exports and also naturally diversifying the export structure (i.e., expand trade at the "extensive margin"). To the extent these new exporters become more productive through a "learning by exporting" effect (for which there is some evidence in the literature, although as noted earlier the evidence is mixed and disputed), there would be a developmental bonus.

However, these supply-side responses will be constrained by the small size of the population of industrial firms in Ethiopia. Given the lead times involved in starting up enterprises, a high priority should therefore be given to early reforms to the microeconomic framework aimed at facilitating new firm formation, both to take advantage of new opportunities in the domestic market for import replacement as well as to service export markets.

Ethiopia has made progress in reducing the number of procedures required to start a company, the time it takes to start a company and the minimum capital required. However, Ethiopia's ranking under the World Bank's *Doing Business* methodology for starting a business still ranks well down the list (93<sup>rd</sup> in 2010) and there is much room for improvement, compared to the least restrictive country in the world: New Zealand requires only one procedure (Ethiopia: five), which takes one day (Ethiopia: nine) and requires no minimum capital to launch a business

enterprise (Ethiopia: US\$ 492 in the 2010 survey). Ethiopia's rankings in other areas important to getting an enterprise going such as hiring workers (98<sup>th</sup> in the world), registering property (110<sup>th</sup>) and getting credit (127<sup>th</sup>) are lower still.

Thus a clear complementary (or even to some extent alternative) policy initiative to the sectoral focus of the GTP would be to target the administrative procedures that serve as bottlenecks to getting new enterprises up and running in Ethiopia. This would allow the market to search out the niches to exploit—which in terms of goods production is playing to the strength of the market as a mechanism—rather than having government try to “pick winners”.

However, it is not enough to simply foster firm formation. Successful firms and competitive products do not emerge on a sustained basis under just any conditions. The modern competitiveness literature emphasizes the importance of industrial districts as the spawning grounds for new firms and products. The essential idea in this literature is that positive externalities such as knowledge spillovers generated by close proximity of competing and complementary forms of human and physical capital enhance the ability of a region to compete. In this context, externalities are aspects of a firm's operations that have “public good” characteristics—that is, the firm does not fully capture all the benefits of its activities. For example, a firm that pioneers the path to exporting a given product to a given market may be imitated by other firms that did not invest in the cost of developing that market. More generally, the interchange of ideas and often personnel amongst companies within a local region acts like technology transfer, expanding capabilities of firms at little cost. Firms in such industrial districts—“clusters” in modern jargon—sit in a rich context, connected to and getting feedback from, factor and product markets, suppliers and customers, collaborators and competitors. It is the information flow within this setting that helps firms overcome the limitations of their own knowledge and enables them to both identify market opportunities and to develop the products that meet the market's needs.

Ethiopia has only very recently developed its first industrial park in Dukem, with China's support. This is a vital first step in the direction of creating a viable, dynamic industrial culture in Ethiopia. Combined with further reduction in the cost of establishing new firms, the development of further industrial areas, and facilitation of links between these industrial areas and with Ethiopia's institutes of higher learning, especially its engineering schools, would be an important step in reducing the microeconomic barriers to Ethiopia's ability to export successfully.

(c) *Reducing trade costs*

Ethiopia's trade costs are high both for imports as well as exports. The main effect of this is to reduce the share of two-way trade in its economic activity. Reducing these trade costs in a context of a high exchange rate and inadequate domestic supply capacity would predictably exacerbate the trade deficit and decimate domestic producers. Accordingly, from a sequencing perspective, the adjustments to the macroeconomic and microeconomic policy frameworks discussed above would ideally be fast-tracked ahead of measures to lower trade costs which would expand the role of trade in the economy.

Ethiopia could slash its trade costs in a number of ways, including in the first instance by reducing the administrative burden of export and import procedures. France, for instance, uses only two documents to import or export; Ethiopia requires eight. Streamlining these procedures both in terms reducing the number but also sharply reducing the time it takes to complete them would represent a major reduction in trade costs, enabling a significant expansion of the role of trade in the economy.

Transportation is a second major area for trade cost reduction. The GTP targets transportation infrastructure as one of the major areas for development in the coming five years but gives road transport a higher priority than rail—the tenders for railway development are to be let only following the completion of the planned expansion of roads<sup>15</sup>. Yet rail is more cost-efficient for long-haul goods transport. Arguably, reversing these priorities would accelerate the improvement of Ethiopia’s export performance and its industrial development more generally. In particular, if the level of ambition of the planned rail projects (especially the Addis Ababa-Dire Dawa-Dewele links) were to be raised to ensure the early completion of a high-speed, heavy-duty, high-capacity rail link to the new world-class port at Doraleh, the main infrastructure basis for seamless multimodal links would be laid.

To gain full advantage from the infrastructure development, two pieces of complementary institutional “software” are needed: implementation of a risk-based approach to customs inspection and entry into a conventional international agreement on movement of goods under customs control to allow most containers to move to port without being un-stuffed for inspection en route.

These various initiatives would be mutually reinforcing given that containers moving on high-speed rail involve much less risk of having their contents changed en route than containers moving on trucks, reducing the need for inspections. Streamlining administrative procedures and sharply reducing transit times also reduces uncertainty about delivery dates, further reducing trade costs.

Implementing these measures would give Ethiopia cost-effective access to a major trade route linking North America and Europe to India and China. Entry into processing trade would become a realistic possibility, significantly improving the prospects for industrializing on a basis other than agricultural production and, by the same token, reducing the risks to the GTP that comes from heavy reliance on a significant expansion of basic agricultural production.

#### *(d) Supporting Measures*

Progress on the three priority areas outlined above is, in my view, the key to achieving the transformational goals of the Growth and Transformation Plan—even if the ambitious growth targets are not met, success on the transformational element would be a great accomplishment. There are several other measures that would support the development of an internationally competitive export base in Ethiopia.

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<sup>15</sup> “Economy to Grow by 50pc to 100pc,” *AddisFortune*, 22 August 2010.

- Improving producer services. Attention could usefully be paid to the market conditions that characterize the producer services sectors. Producer services such as banking, logistics, engineering, information and telecommunications, distribution, etc. are important inputs to manufacturing; improving the availability and reducing the cost of these services thus would facilitate the growth of the traded goods sector. Measures for consideration would include regulatory intervention in areas where market supply is highly concentrated, direct public sector intervention to fill gaps in the spectrum of producer services available, and/or targeting FDI to fill particular gaps (e.g., information and communications services, an area in which Ethiopia ranks particularly low by global standards according to the most recent information society survey<sup>16</sup>).
- Developing connections with immediate neighbours. Uganda’s recent improvement in its rankings on the World Bank’s *Logistics Performance Index* is attributed to a successful project to facilitate transit at the Malaba Border Post in Kenya<sup>17</sup>. Similar efforts by Ethiopia to develop better transportation and border infrastructure connections to Kenya, Uganda and Sudan in particular would support the regionalization of Ethiopia’s industrial development while further boosting the development of its trade relations.
- Trade agreements: while the major constraints on Ethiopia’s trade performance are domestic in nature, two trade initiatives stand out as valuable complements to the measures outlined above. First, Ethiopia’s participation in the Tripartite Free Trade Area (TFTA), which would combine the members of the Common Market of Eastern and Southern Africa (COMESA), the East African Community (EAC) and the Southern African Development Community (SADC), would target the most important remaining conventional barriers to its exports, while also yielding potential benefits in areas such as facilitating the movement of persons, joint implementation of regional infrastructure projects and other forms of regional co-operation. Simulations with conventional trade models suggest Ethiopia would make tidy trade gains from the TFTA, given prior correction of its trade imbalance. Second, Ethiopia’s accession to the World Trade Organization would, in due course, help regularize the still uneven nature of its trade and payments systems (e.g., use of ad hoc *franco valuta* import procedures) while cementing the transformation contemplated above. As Ethiopia proceeds with its various negotiations, consideration should be given to priority to liberalization of imports that are primarily inputs into production, while considering tariff reductions in respect of processed products in a manner that is consistent with domestic production of substitutes.

## 5. Concluding Remarks: Managing Reforms

The above discussion focussed on what might best be done to accelerate Ethiopian development; little has been said about how these reforms might be implemented. The Aide Memoire setting out the conceptual context for the EMPA Symposium, by contrast, references a number of important “how” issues, including the role of new public management (NPM) techniques in the efficient delivery of public services, the potential role of the private sector in delivering public goods, and conversely the potential role of the public sector in filling gaps in areas that in more developed countries are serviced by the private sector. These are big issues that deserve some comment.

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<sup>16</sup> International Telecommunication Union, *Measuring the Information Society*, 2010.

<sup>17</sup> Arvis et al (2010); at p. 19.

Development agendas are largely informed by what has been observed to have worked elsewhere in the past. Thus, the stylized facts of the successful East Asian “tigers” became the main basis for policy prescriptions for other regions. There are several obvious dangers with this.

First, the initial conditions and evolving context for the East Asian “miracle” cannot be replicated in Africa or elsewhere—not least because the global economic and technological setting has evolved and no country possesses the initial endowments of others.

Second, the stylized facts of the East Asian economies reflected ex post outcomes, not ex ante policies. For example, high savings rates in East Asia emerged as a result of rapid growth, not as an ex ante basis for that growth.

Third, as demonstrated by Hausmann et al. (2005), who examined turning points in growth performance, it is difficult to reliably attribute growth accelerations to particular policy frameworks. Studying more than 80 episodes since the 1950s of rapid acceleration in economic growth that was sustained over a period of years, they found that the vast majority of growth accelerations were unrelated to standard determinants of growth and most instances of economic reform did not produce growth accelerations. They conclude as follows: “It would appear that growth accelerations are caused predominantly by idiosyncratic, and often small-scale, changes. The search for the common elements in these idiosyncratic determinants—to the extent that there are any—is an obvious area for future research.”<sup>18</sup>

Finally, and more generally, as emphasized in the literature on public policy “lesson learning” or “lesson drawing” (see, for example, Rose, 1993), there are various contingent factors that bear on the transferability of a given policy; the greater the number of these contingent conditions that are fulfilled, the greater the chance of success in transfer of the policy. Four of these contingencies are of particular relevance for Ethiopia as it contemplates emulating successful models elsewhere:<sup>19</sup>

- (1) Resources: there are sufficient resources (money, public sector personnel, laws) available.
- (2) Institutions: the delivery of the programme is not dependent on unusual institutions.
- (3) Complexity: the policy initiative is not too complex.
- (4) Scale of change: the scale of change that the policy entails is small.

Given these considerations, it goes almost without saying that Ethiopia’s transformational objective must be based on policies rooted in its own reality, however much the policies may be informed by studying successful outcomes elsewhere. At the same time, when it comes to very specific issues, the various benchmarking exercises developed by the World Bank and others provide a wealth of examples that might constitute improvements on the way things are done presently in Ethiopia.

The key “take-away” point from this discussion is that a pragmatic experimental approach to reforms may be required—feeling for the stones to cross the river, to borrow a Chinese saying.

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<sup>18</sup> Note: citation is from the 2004 NBER version of this paper, at p.22.

<sup>19</sup> Cited in Hospers (2004).

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