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Ethiopia: Economic Development in a Harsh Environment: Part 2

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The second part of this review of Ethiopia's economic development examines the strengths and weaknesses of the policies followed and the institutions established in recent years and compares them with the development policies adopted in East Asia. It concludes with a brief review of the country's geo-political position.

Ethiopia's endemic political, ethnic and regional tensions have, once again, come to a head. On 22 June, the head of Amhara state, Ambachew Mekonnen and one of his advisers were killed during a coup attempt that was orchestrated by Asamnew Tsige, the head of security in Amhara. The prime minister, Abiy Ahmed, announced that in a separate attack in the capital, Addis Ababa, Seare Mekonnen, the army chief of staff was killed by his bodyguard. Abiy, in office for just over a year, has introduced unprecedented reforms in Ethiopia.

The shakeup of the military and intelligence services has earned Abiy powerful enemies, while his government struggles to control powerful figures in the country's numerous ethnic groups who are in conflict with the federal government and with each other for greater influence and resources.[1] This crisis may threaten both Ethiopia's economy and stability throughout East Africa.

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Ethiopia has followed what has been called the ‘authoritarian developmental state model’ using a combination of market forces and state intervention. Economic policies were designed to prevent the accumulation of rental incomes in order to increase productivity and competitiveness. Successive governments recognized the need to share power among competing groups so as to keep the country unified. This was a heterodox approach both in terms of economics and politics, and yet it did not conform to the Western consensus, so Ethiopia failed to achieve a high score on world governance indicators.[2]

The aim of Ethiopian policy was to ensure that citizens benefited from the results of development. Despite the focus on results, there was a paradox: the emphasis on the engagement of citizens was at the local level while participation at the higher levels of politics was limited. Party members could advance by achieving results locally, for instance by improving school enrollment or providing better ante-natal care. Decentralization brought the providers of services under the control of local government, making them, at least in theory, accountable to the local communities they served.

The government was committed to enhancing citizens’ public participation in the development of activities and processes through good governance. It set up the Ethiopia Social Accountability Program and Grievance Redress Mechanism, as well as the donor-supported framework of Financial Transparency and Accountability. This made information about local government budgets and spending publicly available in an easily comprehensible way. Through budget literacy training, citizens learned how to provide feedback to local authorities on budgets and the provision of basic services. Local authorities were instructed to consult with citizens before voting on their budgets.

This results’ driven culture, combined with the ambition of local officials to prove themselves, had unintended and unfortunate consequences as well. Targets and deadlines have been pursued regardless of costs, on the assumption that meeting expectations outweighs the costs. Some of these consequences have been noted by senior officials as violations of national policies and standards. Given the decentralized nature of policy implementation in Ethiopia, it has been difficult for federal or even regional officials to monitor such excesses.

State-owned enterprises (SOEs) continue to play a dominant role in the economy. This worked well during the period of growth acceleration as SOEs were used as vehicles for public investment to close the infrastructure gap and to ultimately - encourage the private sector. The dominant role of SOEs meant and continues to mean that there is little space for the private sector. SOEs have pushed out private sector access to credit markets and foreign exchange.

Although it has not followed the Western model, Ethiopia has only partly followed that associated with East Asia. In China, Korea and Vietnam, a strong development in manufacturing and a move away from agriculture resulted in fast economic growth. In Ethiopia, economic activity (measured in terms of output and jobs) has shifted from agriculture and into construction and services, largely bypassing industry.

Criticism of Ethiopia's strategy has come from domestic, as well as foreign sources. According to the minister and prime ministerial advisor, Arkebe Oqubay, despite rapid economic growth, structural change has been inadequate. Rapid growth has not resulted in a shift in the share of manufacturing in employment, output, and exports. Agriculture continues to employ three-quarters of the population and account for nearly 40 percent of GDP. Moreover, the slow growth of exports has been dominated by low-value and primary commodities. The balance of payments constraint has worsened as exports fell short of covering the surge in imports, forcing the country to borrow abroad.

Some 2.5 million young people enter the labor market annually and so job creation is a vital issue. Generating employment is an enormous challenge and has influenced the development of a ten-year plan. The government's *Vision 2025,* which aims to make Ethiopia 'the leading manufacturing hub in Africa', puts greater emphasis on expanding manufacturing output and large-scale growth in industrial employment. This plan would entail an annual growth rate in the manufacturing sector of 25 percent, a fourfold increase in the share of manufacturing output from 5 to 20 percent of GDP, and increased exports from 12.5 to 50 percent. It also requires attracting massive investment in key manufacturing industries, primarily in light and basic industries.[3]

To encourage industrialization, the government has strengthened its institutional, legal and regulatory framework with the aim of promoting foreign direct investment in light manufacturing, especially in the form of industrial parks. A survey of production workers published in 2017 showed that in a typical factory most workers were female, and all had at least primary education and were literate. For many, this was their first formal job. Wages were uniformly low, averaging around $2 per day, but after allowing for the cost of local accommodation this could fall to little over $1 per day. At these pay levels, the cost of industrial labor in Ethiopia was only about 25 percent that of China. The desperate need for employment to absorb surplus labor from the countryside helped keep wages low. Ethiopia is one of the least urbanized countries, and, much like China in the 1980s, has a large, young, and well-educated workforce.

Political unrest, if repeated on the scale seen in 2015 and 2016, could disrupt investment in the manufacturing sector. Electricity grid failures and power outages are severe problems. Plants often have to rely on generators that are four times more expensive to run than electricity from the grid.[4]

The domestic private sector in Ethiopia is weak. Private sector credit equals only about 9 percent of GDP in Ethiopia compared with an average of more than 20 percent in the countries of Sub-Saharan Africa. The economic growth experienced by East Asian states such as China, South Korea, and Vietnam was based on the private sector.

The competitiveness of firms in Ethiopia has been limited by entry barriers to starting a business: access to reliable sources of energy; efficient trade logistics; and exporting with an overvalued exchange rate. Access to financial services is very limited. According to the 2017 Living Standards Measurement Study, the share of adults with a bank account is 54 percent in urban areas, 38 percent in small towns, and 11 percent in rural areas. Limited access to credit constrains investments in nonagricultural activities and constrains agricultural investments for some households as well.

Entry barriers to starting a business, including access to reliable energy supplies, trade logistics and an overvalued real exchange rate, impede competitiveness and limit growth and employment. In addition, bureaucracy, regulatory uncertainty and risk, insecure property rights, and access to land are major constraints. Ethiopia scored poorly on the ‘Starting a Business’ indicator at 179th out of 190 economies in the World Bank Doing Business Report, 2017. In the 2019 report, however, it reached 159 in the ranking.[5]

Energy access is a key issue. Ethiopia is one of the world’s cleanest energy producers with 97 percent of its energy generated through hydropower. It has also improved energy coverage through the grid, with 60 percent of towns and villages covered. However, Ethiopia has the second highest energy deficit, in terms of household connections, in South Saharan Africa. Limited access to reliable energy hinders firm performance and growth as well. Inefficiencies in trade logistics represent a major challenge to enhancing competitiveness, especially in light manufacturing. It has been calculated that for a 20-foot container of garment exports to Germany, Ethiopia’s logistics costs are 247 percent higher than those of Vietnam and 72 percent higher than those of Bangladesh. Inefficiencies in the logistics sector result in high overhead costs for manufacturers, constrain the use of imports, and prevent manufacturing firms from operating at full capacity.[6]

Ethiopia’s economic strategy focused on promoting agriculture and industrialization. There was substantial public infrastructure investment supported by heterodox macro-financial policies. The commitment to agricultural development was reflected in high government spending. While a strong push for infrastructure development at the early stage of development was far from unique among developing countries, the way in which Ethiopia achieved this set it apart.

Although Ethiopia generally did not follow the recommendations of the Growth and Development Commission (2008), it did deliver the recommended impressive rates of public investment with the purpose of encouraging the involvement of the private sector. Despite low domestic savings and taxes, Ethiopia was able to finance high public investment in a variety of orthodox and heterodox ways including keeping government consumption low to finance public infrastructure investment, as well as tapping external financing. Three less conventional mechanisms stand out: First, a model of financial repression that kept interest rates low and directed the bulk of credit towards public infrastructure. Second, an overvalued exchange rate that cheapened public capital imports. Third, monetary expansion, including direct Central Bank budget financing, which earned the government seignorage revenues. Although Ethiopia gradually moved in the direction of a market-based system, it continued to intervene in most sectors of its economy thereby not adopting some of the key recommendations of the Growth Commission, such as ‘letting markets allocate resources efficiently’. Indeed, apart from market-oriented reforms implemented during the 1990s, structural economic reforms have been absent from Ethiopia’s growth strategy in part because of initial economic success. Although it was inspired by the East Asian development state model and shares some common features, it is also different from these countries both in conception and outcomes. Agriculture, for instance, features much more prominently in the Ethiopian strategy than in East Asia. Critically, also, Ethiopia’s economic success thus far has not been derived from the success of numerous private sector firms as in East Asia.[7]

East Asia’s performance in the last quarter of the 20th century was based on the success of largely private sector firms specialized in manufacturing and the penetration of Asia’s manufactured exports into Western markets. The acceleration of growth in East Asia was followed quickly by an increase in domestic saving (which bankrolled development) and in investment that prioritized the private sector because expanding opportunities and government incentives created profitable opportunities, which companies were eager to capitalize on. It was not due to a change in the business environment. Despite recent increases in savings in Ethiopia, it still has a much larger savings-investment gap than the East Asian countries.

Infrastructure did not drive growth in East Asia although it played an important supporting role. East Asian countries invested in infrastructure to accommodate the needs of industry, trade and urbanization, but this followed rather than led the development process. In Ethiopia by contrast, growth has been driven by the development of the infrastructure. China has sustained growth at great cost, by investing lavishly in infrastructure and urban real estate for which there is little immediate demand, but this was not the East Asian norm during its growth heyday. East Asian countries also used exchange rate undervaluation to gain competitiveness and promote growth and exports. In contrast, Ethiopia's real exchange rate has remained overvalued over the past several decades.[8]

Ethiopia is a country of 98 nationalities and peoples, with over ninety languages spoken. It is landlocked and is surrounded by a number of fragile and conflict-afflicted states. Ethiopia plays an important role in promoting regional integration and mitigating regional conflicts. Ethiopia's geopolitical landscape is further complicated by the flow of refugees from the conflicts in neighboring countries. Relations with Djibouti are especially close, as Ethiopia relies on Djibouti for 90 percent of its land-based trade while Djibouti receives power and fresh water from Ethiopia. Since the independence of Eritrea in 1993, when Ethiopia lost access to the sea, most trade-related cargo is shipped via Djibouti. In order to improve regional stability, Ethiopia has supported peace-building efforts in Somalia, Sudan and South Sudan by mediating peace talks and contributing personnel to peace-keeping operations.

At the end of 2017 Ethiopia had nearly 900,000 refugees displaced by conflicts, political events, and civil wars in neighboring countries—South Sudan, Somalia, Eritrea, Sudan and Yemen.[9] There were also an estimated 450,000 internally displaced Ethiopians, and more than 86,000 Ethiopians have sought refuge in other countries (mainly in Sudan). Ethiopia hosted more than 350,000 refugees from South Sudan.[10]

The growth rate has decelerated in recent years although it remains high by international standards. The financial position is precarious, with significant and persistent deficits in the balance of payments and few foreign currency reserves. The development of manufacturing is based on the use of cheap labor and is dominated by foreign rather than indigenous investment. Successful economic development is based on moving up the value chain towards more sophisticated products: this continues to happen in Ethiopia.

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[1] *The Guardian*, Ethiopian army chief killed by bodyguard and regional leader dead in coup attempt, June 23, 2019.
[2] *World Bank Group*, "Ethiopia's Great Run," World Bank Other Operational Studies 23333, 2015.
[3] *Arkebe Oqubay*, "Ethiopia: Lessons from an Experiment," in *The Oxford Handbook of Structural Transformation*, Edited by Célestin Monga and Justin Yifu Lin. 2019.
[4] Alan Gelb, Christian Meyer, Vijaya Ramachadran and Divyanshi Wadhwa, "Can Africa Be a Manufacturing Destination? Labor Costs in Comparative Perspective," *Center for Global Development* (Working Paper 466), October 15, 2017.
[5] *World Bank Group*, "Doing Business 2019," 16th Edition, 311 pp.
[6] *World Bank Group*, "Country Partnership Framework for the Federal Democratic Republic of Ethiopia for the Period FY18–FY22," May 22, 2017, Report No. 115135.
[7] *World Bank Group*, "Federal Democratic Republic of Ethiopia Priorities for ending extreme poverty and promoting shared prosperity systematic country diagnosis," March 30, 2016, Report No. 100592.
[8] Ibid.
[9] *United Nations High Commissioner for Refugees* (UNHCR), Ethiopia, Updated March 2018.
[10] See fn. 6.