

The Devaluation of the Birr: A Layman's Guide, Part 2

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Hitherto, I have been reluctant to post a commentary regarding the [World Bank's suggested](#) birr devaluation measure which is still being debated as we speak. I was reluctant partly because my highly received [2010 commentary](#) addressed many of the issues that seem new today and partly because I did not have (and have yet to) access to the full paper that the World Bank's Ethiopian representatives have worked on. I decided to disseminate this commentary partly to remind concerned individuals that the predictions that my 2010 commentary has made are largely born out to be true and previous birr devaluations measures were largely ineffective. I also observed errors and misunderstandings made by commentators, bloggers and the general public regarding this issue.

At the outset, I agree with Mr. Lars Moller, the World Bank's chief economist in Ethiopia that the birr is overvalued. The main driver of the birr's overvaluation is the country's ongoing high inflation rates. There are indeed other contributing factors to the overvaluation of the birr, some of them being the influx of remittances and foreign aid (these latter two also being partial conduits for the massive [illicit financial flows](#)) as well as the suppressed trade and exchange rate markets- including the suppressed, battered and interfered parallel exchange market. Another way of observing the birr's overvaluation is this: the birr is overvalued because its exchange rate exceeds what the open market would be willing to pay for it and because Ethiopia's general price level is higher than the general price of comparable countries. This basically means that the birr would have dramatically depreciated were it allowed to float.

To see the paradoxical and weird (non-market driven) nature of the Ethiopian situation, one can look into, for example, the long-time co-existence of high inflation rates and low interest rates (and negative real interest rates.) Indeed, negative interest rates, coupled with the ruling party's practice of credit channeling have played huge roles in impoverishing savers and transferring wealth from the general public and the nation as a whole to party-owned conglomerates and elites who have close ties with the government.

The reader needs to know that there is difference between nominal and real exchange rates. The nominal exchange rate for the birr (or any currency), is the price of birr in terms of a foreign currency. This is indicated by the birr- U.S. dollar exchange rate, which was \$1 U.S. = 19.7720 birr as of July 30, 2014. Just before August 31st, 2010, the birr/dollar exchange rate was 13.6284. On September 1st, 2010 (after the official devaluation), the birr was quoted by the National Bank of Ethiopia at a weighted average of 16.3514 birr against the U.S. dollar. Given the current birr/dollar exchange rate of 19.7720, the reader can easily observe that the birr was continuously, quietly and in a stealth manner, devalued by about 21% (calculated as $(19.772 - 16.3514) / 16.3514$) since September, 2010. At the same time, annual inflation rates in Ethiopia from [2005 to 2013](#), respectively, were 9.95%, 12.20%, 17.25%, 43.80%, 10.57%, 8.12%, 33.00%,

23.33% and 8.07%. The reader can observe from this that the exchange rate has not been coping with the country's inflation rates.

It is important to recognize that the above (nominal) exchange rate tells nothing about the REAL buying power of the birr or the country's competitiveness. The real exchange rate is used to measure the buying power of the birr and the competitiveness of Ethiopia's exports. By definition, the real exchange rate (r) is the nominal exchange rate (e) adjusted by the ratio of foreign price (P^f) to the domestic (home) price level (P^h). Mathematically, it is represented as

$r = e \left(\frac{P^f}{P^h} \right)$. Using this equation, suppose that Ethiopian the nominal birr-dollar exchange rate

is 20 birr = \$1 USD. With this hypothetical example, the above equation becomes: $r = 20 \left(\frac{P^f}{P^h} \right)$.

If domestic prices P^h happen to be greater than prices in the U.S. (P^f), the birr would buy more in the U.S. (that is, importing U.S. goods become cheaper) than in Ethiopia, thereby making the birr real exchange rate to appreciate (for the birr to be overvalued). Assuming that P^h represents the aggregate price of Ethiopian exportable commodities, the appreciation of the real exchange rate negatively affects the country's competitiveness.

I am assuming that Mr. Lars Moller, the World Bank's chief economist in Ethiopia and his collaborators have done a comprehensive simulation and have carefully calculated the elasticities that satisfy the required Marshall-Lerner conditions before suggesting a devaluation measure. Having said that, I grant to anyone who may legitimately question the validity of the Ethiopian data variables used to complete the necessary calculations, which in turn make the purported simulation and calculation to be largely suspect. For example, the aforementioned simulation (calculation) would rely on the accuracy and knowledge of the country's aggregate price levels (price indexes) relative to its trading partners, the price indexes of the country's exportables and non-exportables, etc., and all the other conditions that I stated in my [previous article](#) to make the devaluation effective. To appreciate the problems of calculating real exchange rates in the Ethiopian context, one can look into, for example, the price of coffee, whose domestic price fetches more than the revenues it garners from its exports. Staying with coffee, one should not forget the unwise decision of the government to push specialty buyers away and force coffee exporters to sell their coffee beans through the Ethiopia Commodity Exchange (ECX). In addition to the resultant [tumbling of the country's earnings from coffee](#), the government's decision to mix high and low quality beans together should have resulted in the quality of the Ethiopian exported coffee to be different from other coffee exporting countries. This makes comparing price indexes somewhat untenable.

The Marshall-Lerner (M-L) condition is as follows: even though devaluations may lead to a rise in exports, the income from exports may or may not exceed the decrease in expenditures on imports. It all depends on the responsiveness of exports to the declined birr and responsiveness of imports to the high costs of imports. If, for example, foreign demand for Ethiopian exports happens to be responsive to the birr's devaluation (i.e., export demand is elastic), the weakened birr should result in higher Ethiopian exports. Moreover, if Ethiopian imports become highly responsive to the increased import prices (that is, imports are highly price elastic), then the weakened birr should reduce imports in a dramatic fashion. For the M-L

Condition to be met (that is, for devaluation to induce a shift to greater export revenues and have any positive impact on Ethiopia's trade balance), the combined elasticities of demand for exports and imports should be greater than one (that is, it should be elastic.) But, export and import demands may not be elastic. That is, exports and imports may not be responsive to changes in exchange rates after all. If so, the devalued birr may have a worsening effect on Ethiopia's trade imbalances. If the weakened birr fails to change Ethiopia's exports, real incomes from exports would decline since the birr is weaker than before. Similarly, if Ethiopia's demand for imports is highly inelastic (that is, Ethiopia continues to buy foreign goods even though their birr prices have risen), the country's expenditures on imports would rise, thereby worsening its current account balances, Ethiopia's import costs would rise while export income from selling its commodities would decline. As I argued in my 2010 commentary (and as the country's trade imbalance clearly shows), Ethiopia is a net importer. According to Professor Minga Negash, the hunger for imports in Ethiopia is high in part because of the government's many mega projects.

Related to the M-L condition is the J-curve effect or the J-curve hypothesis, which is used explain a country's trade balance over time after devaluation. The hypothesis says that a country's trade balance may indeed deteriorate at the initial stage of devaluation but it eventually improves (over the long-run.) as elasticities improve. The empirical literature regarding the validity and observability of the J-curve effect is indeterminate. But, we know that the birr has been continuously devalued since 1995. The fact that there is now a renewed call for an additional and official devaluation of the birr clearly indicates that the previous devaluation measures did not work and the theorized J-Curve effect did not apply for Ethiopia.

As I indicated above, the birr has been devalued since 2010 without the World Bank's uncalled for fanfare. The mere fact that the World Bank is suggesting another (announced) devaluation is quite puzzling, indeed, since announced devaluation measures would just add more fuel to price hike expectations and the already existing inflation rates. Could it be that the World Bank announced the devaluation measure in order to provide cover for the government to officially devalue the birr? Or, is this being done so that both Ethiopia's creditors, foreign buyers and potential investors could hear them loud and clear that Ethiopian authorities are doing something to overcome the bad situation that the country is in? Or, could it be that Mr. Lars Moller and the World Bank have come out swinging to show that they are doing something important in Ethiopia? For what good reason has the World Bank crept into the affairs of its sister institution (i.e. IMF: monetary policy?) As I showed in my [2010 article](#) dealing with the same issue, one of the multitude and important conditions for devaluation to be effective is for Ethiopia's trading partners not to resort to devalue their own currencies (that is, for them to refrain from a currency war known as competitive devaluation— a "beggar-thy-neighbor" scheme . Would the World Bank provide similar advices (of devaluation) to other countries? What if Ethiopia's trading partners complain about the devalued birr working at their countries' expenses? How could the currency wars and the devaluation schemes be stopped? It is surprising that the World Bank inserts itself in this kind of untenable and destructive policy!

If the Bank or its representatives want to show us they are doing something important in Ethiopia, wouldn't it be wise for Bank to focus in its purported core missions, such as the alleged reduction of poverty and promoting "[shared prosperity?](#)" Wouldn't it be wise for the Bank to look into why its aid has fueled corruption, trapped millions of Ethiopians with a vicious

cycle of poverty, created a cycle of dependency in Ethiopia, as [I show elsewhere](#)? Wouldn't it be good for the Bank to look into how and why its aid has been highly manipulated and politicized and "[used as a powerful tool of political control and repression](#)?" How come the World Bank, as a major donor agency to Ethiopia, has been silent about the expropriation of land from peasants by powerful elites and as well as the rampant land speculation schemes? How come the World Bank kept silent until cronyism and political-party ownership of the commanding heights of the Ethiopian economy and resources has resulted in a highly corrupted resource-ownership & political structure, [otherwise known as state capture](#)? It is important to note that, my ongoing research has indicated that the new ruling elites of Ethiopia used to capture the commanding heights of the Ethiopian economy and its resources using the ill-advised privatization and economic reform scheme that the World Bank and the IMF pushed for (and took a blind eye during the entire robbing process!) That devaluation hurts the poor most is a well-known economic fact. Perhaps the World Bank is worried about Ethiopia defaulting on its loans rather than about poor Ethiopians who continuously get battered by the endless devaluation and the unbearably high cost of living. This, of course, is in contradiction to its purported core missions. Nevertheless, the Bank's suggested 10% devaluation will be totally insufficient for closing Ethiopia huge and unsustainable trade gaps and indebtedness (assuming that it is implemented and it works.)

In any event, the fact that the authorities have decided to continuously fiddle around the country's currency reveals that they are incapable of resolving the structural problems of the country's economy. It also shows, sadly, that the current Ethiopian authorities have not learned that sound macroeconomic policies are the road for success and that continuous devaluation could not be a panacea for the country's economic ills. The current talk for an official birr devaluation indicates the uncertain prospects of the country's economy. Of course, this fact is in contradiction to the government's position of a booming economy. Repeated devaluations measures are also indicative of the fact that previous devaluations did not work, that there is no J-curve effect for Ethiopia, as I illustrated in [my 2010 somewhat lengthy commentary](#). Unfortunately, the Ethiopian authorities continue to do the same things, foolishly expecting different results. The continuous devaluation of the birr and this World Bank's suggestion to officially devalue the currency will undoubtedly exacerbate the rising cost of living in the country. The 2015 upcoming "election" would also entail more expenditures on the part of the government. Add to these the government's decision to increase the salary of public sector workers beginning July 2014, whose real incomes have been eroded by the continuous rise in inflation rates. As is customary for the ruling party, it already has begun blaming the private business sector for the problems that the government has brought on itself and the Ethiopian people. Reports indicate that the ruling party, absurdly, has already warned or closed down over 400 shops alleging that they have raised their prices using the government announced salary increases as veiled pretexts. Moreover, the politically motivated excessive tax burdens have been forcing many domestic enterprises, particularly those which are not ethnically or politically aligned with the ruling party, to be delinquent on their tax payments. As a result, many of these enterprises increasingly have little incentive to expand their capacity, a good portion of them facing the prospect of closures. Such politically motivated measures

would undoubtedly exacerbate the largely [supply-shortage-driven inflation](#) rates and high costs of living.

Thanks to the World Bank, now that a devaluation measure is suggested (announced), the genie out of the bottle- that is, prices will rise. So, buckle-up for a hard ride, poor Ethiopia!