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HOW TO PASS FROM A WAR TO A PEACE ECONOMY :
THE ETHIOPIAN CASE
RESEARCH PROGRAMME CONTRACTED BY THE EC TO DIAL
Nber R/821

PRESENTATION OF THE RESEARCH PROJECT
CONTRACTED BY THE EC TO DIAL
DIAL'S EXECUTIVE SUMMARY

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TABLE OF CONTENTS

I - PRESENTATION OF THE RESEARCH PROJECT CONTRACTED BY THE EC TO DIAL

1. Concern on Ethiopia has led the EC to contract DIAL, a Paris-based study group, to deal with a research programme on "how to pass from a war to a peace economy in the Ethiopian case". The programme had to focus on **two subjects. The first purely related to Ethiopia had to throw some light on what could be the major EC's fields of action to help the country to recover. The second had to indicate what could be grasped from the Ethiopian case to ease analogous transition of other developing country.** To do the job DIAL has resembled an international working team of economists. In accordance with the terms of reference of the research programme tasks were assigned. The final product to deliver to the EC was expected not later than end of September 1992.

2. There are twelve draft reports resulting from the co-operation between an European team and a group of Ethiopian economists from A.A. University and the Ministry of Planning and Economic Development. The research programme was co-ordinated by P. COLLIER, Director of the Centre for the Study of African Economies (CSEA-Oxford University) regarding the European team and TAYE MENGISTAE from A.A. University regarding the Ethiopian one. The general co-ordinator was G. de MONCHY, Dial's Director.

European team

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3. The contents of the draft reports are based on the findings of the DIAL missions to Addis Ababa from Nov 22 to Dec 3, 1991 and March 22 to April 3, 1992 as well as recently published information from several sources both Ethiopian and international. During the missions a considerable number of interviews and exchange of opinions with members of the EC delegation, the World Bank, A.A. University professors, officials from different Ministeries and Board were extremely important to understand some of the Ethiopian Economy and Society. It would be too long to list the persons encountered. To everybody DIAL's working team wants to express a sincere "thank you".

4. The DIAL's works drawn upon the following contributions :

1. Presentation of the research project
   DIAL's executive summary
   by M-P. Verlaeten

2. Transitional Economic Policies in Ethiopia :
   A Synthesis of Priorities
   by P. Collier, D-L. Bevan and Taye Mengistae

3. The Macroeconomics of the Transition to Peace in Ethiopia
   by P. Collier and J-W. Gunning

4. Fiscal Aspects of the Ethiopian Transition
   by D-L. Bevan

5. Agricultural Supply Response
   by F-B. Soares

6. Grain Market DE-Control in Ethiopi
   by J-P. Azam

7. -Ethiopia's Economic Policy during the Transitional Period
   -Ethiopia's Economic Policy during the Transitional Period
   Summary and conclusions
   by M-P. Verlaeten

8. Notes on Trend in the Macroeconomy of Ethiopia
   by M. Manyazewal

9. Incomes, Employment and Industry
   The Challenges of the Crisis in the Urban Rural Nexus
   by T. Mengistae

10. Privatization and Deregulation in Ethiopian Industry
    (Problems, Prospects and Impact on the Economy)
    by E. Chole

11. The Financing of Government Expenditures
    by T. Mulat

12. Institutional Mechanisms of Access to Resources in the Smallholder Agriculture
    by A–B. Kello

13. The Informal Economy in Ethiopia
    by T–A. Andabo

5. The terms of reference of the project are presented through an ad–hoc document to which it has to be referred to.

6. Going further than required by the terms of reference has led Dial to attempt to throw some light on the behaviour of some economic operators as on some dominant variables of the Ethiopian economy through econometric analysis. The note which for instance looks at the Birr parity change or the capital market flexibility accompanies the already mentioned contributions.

Ethiopia : An economy in transition. Some relevant market parameters
by N. TROUBAT (OECD)
M–P. VERLAETEN (DIAL)

II - EXECUTIVE SUMMARY OF THE MAIN RESULTS

7. This summary is organized as follows : first, a presentation of the economic conditions at the end of the civil war ; second, a focus on growth expected to be grasped during the transitional period at macro and sectoral levels ; third a presentation of major constraints to growth ; fourth, a scrutinity of the Economic Policy during the Transitional Period (EPTP) and fifth, some appropriate conclusions for the EC. Through that note it has been attempted to value each author's contribution. Nevertheless, the note has to be referred to as how DIAL's staff, mainly wishes to answer to the EC's questions using works done by the members of the working team.

A - THE ECONOMIC CONDITIONS AT THE END OF THE CIVIL WAR

8. At the end of the civil war, **the Ethiopian economy** is about to collapse. It has become a **supply–shortage economy** under the DERG–regime. Even if shortage increased at the end of the 80s because of the civil war, it is not only the result of that war. More fundamentally it is due to a sample of facts. A combination of civil war, anti–democratic choices, policy distortions, environmental degradation, an unfavourable demographic dynamics, adverse external factors (recurrent drought, natural calamities, external shocks) and a host of structural problems (backward technology and methods of cultivation, weak linkages between sectors, ...) has been responsible for the disappointing performance of the economy from 1974 to 1990. Shortage has been accompagnied by a lot **of restrictions limiting private operators' responsibilities at various levels**. This has been particularly obvious regarding peasantry agriculture, the dominant sector of the economy. Shortage and restrictions have also been accompanied by **an increase of the weight of the public** sector in the economy and a **process of informalization of it.** Both have resulted in an increase of the budget deficit. In the case of the former because public expenditures increases were not matched by fiscal receipts increases and in that of the former because the Ethiopian fiscal basis was touched. **On the external trade front, the situation was also unhealthy**. The export to import ratio decreased. By the end of the 1980s the import cover of the country was less than ten days. This accounted for with decreased saving compared to investment meant that **Ethiopia became a two gap country**. Further **the country's debt position deteriorated deeply**. At the end of the 1980s it owed approximately US$ 3 billion to western donors and had a Russian claim of around $ 7 bn for importation of Soviet–supplied military equipment by the DERG. In the preceding framework pressures to devaluate the Birr, the local currency linked to the US$ since February 1973, increased giving rise to a parallel exchange rate and some capital outflows.

9. The very high share of public expenditures in GDP (45%) compared to African standards was largely due to military and defense expenditures productive investment being indeed one of the lowest in the world and upkeep and maintenance costs being very often neglected. This was also the result of an expanded bureaucracy and state administration and the conduct of endless "campaigns". Increased public expenditures and constrained public receipts led the Ethiopian authorities to raise taxation and to extract more and more from the state firm's revenues through various ways (increases of the rates, modifications to the tax system). But this was not enough to cope with structural budget deficit. Borrowing from the banking system also increased in the framework of modified legal rules through various proclamations not yet abolished today. Inflationary pressures from the budget were largely contained by a continuous monetary deepening or rise in the money supply/GDP ratio. At the end of the 1980s nevertheless inflationary pressures started to surface. Structural budget deficit in conjunction with a regulation prejudicing private initiative have resulted in a large **crowding–out effect on private investment** although nominal interest rates stayed rather low comparatively to other developing countries with the same features.

10. Rather paradoxically when the command economy vanished in Ethiopia, a market–based one is in the process to be substituted for it in the production of many goods needed by Ethiopian people in their current day living. Although the process and profile of informal economies are historically specific depending on the relationship between the State, capital and labour in each country, in Ethiopia, it was due to the State's reduced legitimacy and operationality particularly at the end of the DERG's period and people seeking for solutions to increased poverty and extreme destitution.

11. **At the sectoral level**, Ethiopia is also in dire conditions. **The Ethiopian agriculture** which dominates the economy in terms of value added (40 per cent at least), employment and export receipts (80 to 85 per cent) **is in dramatic state**. At the end of the 80s food production per capita is about 12% points lower than at the beginning. This is due to a set of conditions amongst which recurrent droughts which also kill million people. Famine becomes a permanent fact in Ethiopia, so that people question to know wether famine has become an Ethiopian fatality. Further, the agriculture average yearly income (U$ 140) is approximately three times lower than that of the industry sector and eight times lower than that of the services. Moreover, within the agriculture sector the yearly average income for people from the subsistence sub–sector is only US$ 35. So, extreme poverty remains also a permanent fact in Ethiopia. The agriculture sector is also featured by unstainable growth. Indeed, soils are particularly eroded in the Highlands which accounts for 90% of the population and economic activities, 95% of land cultivated and two thirds of the lifestock. This results in

potential yields loss of about 1 to 2 per cent per year. At medium term about 10 million people could again be displaced being unable to derive their food and income from cropping their own lands. World Bank indicated that to feed its population, Ethiopia should increase its domestic production by 3.3 per cent on average during 10 years without ceasing to import. The preceding indicates that any new agriculture supply policy should likely be accompanied by an international food–aid one.

12. **The industry sector (mining, manufacturing and construction included) (16 per cent of GDP) has a limited volume of production.** Within the sector, manufacturing (about 100,000 people) covers only a small proportion of domestic demand. It has developed more on ideological grounds rather than economic rationality. As a result, its intersectoral linkage is weak at the opposite of its import (and so exchange rate) content. As in the case of agriculture, industrial private investors have been discriminated strongly. For instance, in terms of past lending practice. Private entrepreneurs have had to rely on their own resources or on non–bank sources of finance for both there start–up and working capital needs. Industry comprises mainly large–scale plants shielded from competition in markets by the operations of the public distribution system, which was obliged to accept and market the product of public sector factories and farms and by import policy. In the light of available studies it is not really possible to arrive at a firm conclusion regarding the economic efficiency of these enterprises. At the opposite, in terms of financial performance, the situation is clear : the number of losing enterprises has been steadily rising, especially in the last two years.

13. **The construction sector is quite remarkable** small, employing 37,000 people according to the 1984 census. Although this could appear rather paradoxical in an economy facing a rural–urban nexus leading to rural migrations (although not dramatic in terms of African standards) and an employment challenge (soldiers to be demobilized but not only), this is not so more the case when referring to the evolution of the **informal sector in Ethiopia.**

14. **Ethiopia is embarked upon a transition to be fully informal or black–marketed** although it is rather difficult to indicate the importance of informal activities given the lack of conclusive and consistent data. Nevertheless let us just throw some light on these activities by indicating that :

(i) a 1983/84 survey by the Ministry of Agriculture estimated that institutional credit accounted for only 20% of total credit with informal sources of credit accounting for the remaining 80 per cent ;
(ii) unregistered exports of coffee and livestock alone could amount to Birr 258 million (US $ 125 million) per annum. This is about 45 per cent of official exports in 1990/91 ;

(iii) the number of informal employees of public construction enterprises was estimated by the Ministry of Planning and Economic Development (Dpt of Urban Devlpt and Construction, 1992) to be three times as big as the amount of permanent employees ;
(iv) 80 per cent of the Chamber of Commerce's members at A.A. are not registered as entrepreneurs.

To conclude on this sector, it has to be said that it has become an essential one to account for given its growth and social implications. Therefore, it is a key of any transitional growth and political process under way in Ethiopia.

15. Although the military government attempted to introduce policy reforms in the framework of requirements for western international aid likely but not exclusively, these came too late to make any appreciable global macroeconomic and social difference. Ethiopia remained one of the poorest country in the world with a constant dollar GNP per capita lower than in 1965 at the end of the 1980s. Further Westerners became accustomed to contemplate on their television screens Ethiopian people dying from starvation.

16. To summarise at the end of the civil war, the new Ethiopian government has to cope with a set of challenges interacting on both the political and economic fronts. They are :

(i) peace to secure ;
(ii) relations between people to improve as much as these ones with the State ;
(iii) the country to rehabilitate ;
(iv) food reliance to modify so as to reduce risks to famine for the present ;
(v) demobilized soldiers to accomodate properly ;
(vi) a process of increased informal activities to manage ;
(vii) external resources to secure in the framework of a position of illiquidity and quasi insolvability ;

and

(viii) poverty to alleviate.

All this presumes :

(ix) a state budget and moreover an evolution of it permitting to account for political, economical and social concerns.

B - EXPECTED GROWTH DURING THE TRANSITIONAL PERIOD

17. During the transitional period, **growth analysed at macro level** is expected to be grasped in the context of an Ethiopian economy undergoing five distinct transitions permitting to get and improve a basic market-based economy. The growth effects will depend on a set of conditions. Amongst the economic ones it can be referred to the economic policy implemented by the government both in terms of its content, sequencing, speed of implementation, as to the private operators' uncertainty and expectations. In this framework to account for credibility gap between the business community and the government is as much important as to decide on grounds of economic (and social) rationality, only.

18. The Ethiopian economy is undergoing five distinct transitions any one of which would have major effects. **First**, in the Northern part of the country after many years of war there is peace, giving rise to opportunities for reconstruction in the region, permitting radical reshaping of the budget, but creating problems of demobilisation. **Second**, in the Southern part of the country there is a new situation of low-level insecurity which, while not a threat to the existence of the government, is restricting economic activity in the most productive area of the economy. As a result, most of the potential coffee production is either being consumed, not harvested, or smuggled rather than going through official export channels, and the large potential gain from food market integration is yet to be realised. **Third**, until almost the end of the DERG the Ethiopian economy was highly regulated and heavily taxed. One of the most fearful consequences of this control regime was that the periodic droughts which characterise parts of the country gave rise to severe famines. The tentative liberalisation begun in the last days of the DERG is now more extensively on the policy agenda, and has the potential both to alleviate the risk of famine and to enable economic growth, but as with other liberalisations there are concerns (which may or may not be valid) about short term consequences. **Fourth**, after a long history of economic and political centralisation, power and revenue are being decentralised to the regions. In the case of Eritrea the region is already fully autonomous. **Fifth**, the process of government is in transition to democracy. This may give rise to a revolution of expectations, such as has happened elsewhere, and it creates important issues of timing : some decisions are appropriately left for an elected government, whereas others need to be taken prior to its inception so that it inherits a viable economic situation rather than one in which all painful decisions have been left to accumulate.

19. **Growth analysed at sectoral level**, will be maybe much more strongly influenced by the government's economic policy than at the macro level. For instance, on the **peasant agriculture front** or agriculture output supply one, one key issue is the increase to the price paid to the farmers. Analysis of the Ethiopian situation seems to indicate that Ethiopian

farmers could positively respond to price incentives although under specific conditions. Therefore, **liberalisation** of output markets already in progress and advocated in the government's policy document could be expected to bring higher farm–gate prices and consequently increases in supply. It is nevertheless worth indicating that producer prices will only rise to the extent that the market structure for agricultural produce is competitive. The liberalisation should not lead to the dismantling of AMC (Agriculture Marketing Board). On the contrary AMC would have an important role as a stabilization marketing board, namely in managing stock facilities and improving distribution conditions. The same reasoning applies to coffee and livestock exports like hides and skins for which the existence of considerable smuggling activities is the best indicator for the need of market liberalisation. Whatever would be the roles devoted to AMC, the government should resist any pressure to confer monopolies upon them by banning private traders. The appropriate structure is for competition between public and private agencies. In addition, in what concerns the expansion of coffee and other potential export crops like tea or cotton **the clarification of land property rights** appears decisive in order to attract the required private foreign investment. Similarly, **rights over water** need to be clarified. Evidence suggests that the social return on small–scale irrigation is high, but the private return will often fail to reflect this unless the rights to use and sell water are well–defined and enforceable. In nomadic areas and in areas with irrigation facilities in peasant agriculture this is an urgent issue. A further "common property" problem relates to **grazing rights** and **community forests at the village level.** This institutional vaccum in rural areas limits the scope for socially agreed regulation of usage and so leads to over–exploitation. Since many assets (such as tress) can be stripped very rapidly even though they may take many years to establish, this is an urgent problem to solve. The question of land property rights deals directly with the future of state farms and co–operatives. It does not seem hazardous to foresee the progressive fading out of such structures as a natural result of the liberalizing process. In the input and services markets, however, the dismantling of Service Co–operatives cannot be considered in the same way, although some of them have already been dismantled as the result of looting. Services provided by SC and by AISCO cannot be stopped without causing serious disruption in production. This does not mean the maintenance of the criteria used by AISCO in fertilizer distribution which has to become unbiased towards peasant farmers. Last but not the least the modernization of Ethiopian agriculture through a more correct price policy, better marketing conditions and improved technologies, will have to take place under **appropriate rural infrastructure, water management, soil conservation practices** and **rigorous control of deforestation** in the framework of a **sound use of natural resources.**

20. On the **industrial front** not much has to be expected because of the serious obstacles standing in the way of massive privatization in Ethiopia today. Major constraints are :

a) The great degree of policy ambivalence on the relative roles of the public and private sectors which leads to ambiguous commitment to privatization ;

b) The perception of the general policy environment within which privatization would be attempted. Unless such an environment is perceived to create an atmosphere of competitiveness and a relaxing of the stifling patronage of the state, whatever measures of privatization are initiated are unlikely to generate the desired benefits. It would be fair to say that such a perception does not exist in Ethiopia now, especially within the business community. Between the government and the business community there is always a credibility gap to reduce, at least ;

c) Unfavorable marginal tax rate on profits. Although this rate has recently been reduced from 89% to 59% (for incorporated private enterprises, only) it is still considered extremely unfavorable by private investors. Further individual entrepreneurs are still subject to the very prohibitive rate of 89% ;

d) Heavy constraints emanating from the backwardness of the economy. Amongts these ones the supply of hard currency which is very limited ;

e) The lack of interest from the business community for large-scale and unprofitable plants likely also unefficient, etc...

For these reasons, privatization can only be a longer-term objective and the real current issue is the reform and management of public enterprises rather than their sale. The government could also choose the option of liquidation but this raises the unemployment question during the transitional period.

21. **The construction sector** can be a very important one in the provision of safety net policies for demobilisation but not only. Indeed, it is a labour intensive sector (unskilled workers, mainly). Further, its import content is not high compared to the rest of the industry sector. Its growth and employment impacts could therefore be rather high in case of the government implementing a construction programme to restore the badly neglected urban and rual infrastructure. If one assumes the minimum wage it would cost less than $ 100 m to employ 250,000 workers for a year. **The labour force used could be first achieved by civilianising those parts of the military organization which undertook infrastructure activities.** It would be expanded after.

22. In the light of recent past analysis, **informal activities** could develop strongly during the transitional period (and over). Although it is not possible to indicate how they would react in front of the government's policy.

C - CONSTRAINTS TO GROWTH

23. There are a lot of interacting constraints which could very detrimentally affect expected growth both at macro and sectoral levels. The most obvious economic ones are :

(i) what **inflation** rate to expect ?
(ii) what situation of the **budget deficit** to get ?
(iii) what **market liberalization** to face with ?
(iv) what **effective local business community's response** to cope with ?
(v) what **peasant agriculture's response** to get ?
(vi) what level of **international aid** to benefit from ?

Amongst the non–economic ones, that of securring **peace** and **social stability** in the whole country are the most obvious.

C–1 The fiscal deficit and inflation

24. The evolution of Public Finances is a key issue of the Ethiopian economic transition through its impacts on growth but also its dependency on it. The government has announced a fiscal policy to achieve fiscal balance at least at medium term. Apart from being a question of credibility and economic rationality (to avoid crowding out and inflationary effects) this is also a question related to international funding. Indeed international donors would likely require a reduction of the deficit even if they are aware that they would have to finance it during the transitional period and maybe over. International funding would then depend on some **acceptable** budget deficit. Acceptable budget deficit could very well lead the Ethiopian government to face with difficult choices. For instance, one of these could be to increase fiscal receipts through an agricultural policy remaining strongly from the extractive type. This would reduce the budget deficit and the related inflationary impacts at the costs of expected growth, improvement to food production and people poverty and government's legitimacy and credibility. This could also lead him to relax applied austerity monetary policy alleging that inflation coming from the budget is just one part of a wider inflation process Ethiopia has to cope with. So, better would be to work on the inflation global front than on one of its facet.

25. In the preceding framework there is a need for a **contingency plan against both unacceptable deficit and related inflation.** Such a plan should be capable of both financing a deficit without resort to money printing and reducing existing money balances should the demand for them decline. There are two possible buffers against budget inflation : foreign borrowing and non–monetised domestic financing. Foreign borrowing through public agencies is generally not well–suited to this contingency role. Indeed, conditionality attached to the budget deficit means that aid is liable to be curtailed at precisely the time when it is most needed. Hence, the only option is for contingent non–monetised domestic financing. In developed countries this can be done through varying the sales of government bonds or public holdings of equity. Although the Ethiopian government, like most governments of developing countries, does not have these options, it is fortunate to have suitable alternatives. The government is in the position of owning so many assets that some of them, such as the **housing stock**, can if necessary, be sold without implications for production or employment. The sale of some of these assets could be coordinated by the Central Bank as the equivalent of selling bonds. It would, of course, be much easier to (re)create an urban housing market than to create a bond market. The central point of this analogy with a market in government bonds is that the amount sold can be contingent upon the evolution of the budget deficit and the demand for money, or indeed, can be guided directly by the evolution of the price level : whenever it is desired that the price level should rise more slowly, more assets can be sold.

26. The contingent stabilisation strategy should be contrasted with privatisation as a liberalisation programme. In particular, it has nothing to do with reorganising industry. Further, it can be implemented in such a way that it does not have severe distributional implications. Substantial amounts of government–owned housing in major urban centres are rented by relatively high income groups. Often these tenants sub–let at rental rates up to ten times the rent which they are paying to the government. Business property is similarly rented out by the government at rents which fall far short of market levels, resulting in very high payments of key–money to the nominal tenants. While potentially the government could capture this lost revenue by raising rents, this process would take time because the government is also the landlord for low income groups so that a standard, across–the–board rent increase would be unacceptable, and a more targeted rent increase would require a comprehensive review which cannot be done in the short term. However, the fact that high prices are already paid as key–money shows that selective sales of the government building stock would be quite feasible even in the short term. A further category of assets which might be sold is that of the **smaller public enterprises in parts of the non–tradable sector,** such as retailing and catering. These businesses are sufficiently small that their capital value is not

beyond the reach of many residents and employees. Further, being in the non-tradable sector, the capital value of the activities is not subject to major change from exchange rate realignment (which is one of several factors which could preclude early sales of large manufacturing enterprises). To the extent that the government covers its deficit by asset sales, as suggested above it is depleting its net worth. It would therefore be appropriate to offset this by increasing public sector capital formation from the extremely low level which it reached in the 1990/91 budget. This is consistent with the suggestion concerning safety net expenditures on public works. In effect, the government would be exchanging residential and commercial property for new public infrastructure rather than depleting its net worth.

C-2 Market liberalisation

27. **Goods market liberalisation** leading to competitive markets would positively influe on expected growth. The most obvious example has already been given in the case of peasant agriculture output supply. Another example relates to efficiency. The grain market analysis suggests that increased freedom of trade improves the efficiency of the market through a reduction in the spatial dispersion of grain prices. This reduction is a basic ingredient in determining the gains from trade which the economic agents can get from improved market unification. Obviously, although the analysis suggest that one can expect a positive response of the trading sector and the peasants to a freer environment, all would depend on the global market liberalisation promoted by the government. **On the factor market front,** positive impacts can also be expected. Indeed, modifications to the Labour Law will increase labour market flexibility which was strongly advocated by the business community. Here it is worth indicating that increased labour market flexibility can only occur under very specific conditions. Although not being fully acceptable by the business community this is a first step likely paving the way for other ones. In this case, too, all would depend on how the new Labour Law would be applied.

C-3 The local business community's response

28. The local business community's response depends fundamentally on how some credibility gap existing between that community and the government can be closed or at least be reduced and on policy uncertainty. The government's economic policy carries with it uncertainties as to which measures would really be implemented and when. There is an interacting framework for how the business community would appreciate uncertainty depends on how wide is the credibility gap as well as what its nature is : ideological or other. Further, the credibility gap is also influenced by policy uncertainty. In Ethiopia, the credibility gap is dominantly an idelological one. It received recently (1991) further legitimacy the business community being

not invited to participate to the discussions and works to choice an Economic Policy for the country during the transitional period. The ideological credibility gap leads the business community to underprice what the government has already decided at the opposite of what it should have done. It leads also to overvalue policy uncertainty featuring any political coalition of any country and undervalue policy certainty. The result or the cost is private investors remaining on a waiting position. For how long nobody knows.

C-4 The peasant agriculture's response

29. Although being clear at the theoretical level (positive elasticity of output supply under specific conditions) practically the situation could very well be not so obvious. Indeed, the government needs money to stimulate growth. In this respect, there is a risk to get an economic policy towards agriculture output supply which would remain from the extractive type even mixed with market incentives. The costs would be constrained expected growth plus social instability. The non-negligible probability of the risk could explain the government's position on the fertilizers issue in front of the World Bank (see at paragraph 30 below).

C-5 The level of international aid

30. International aid would first appear through the financing of the Ethiopian Economic Recovery and Reconstruction Programme (ERRP). Funding covering more than 90 per cent of the ERRP has been supervised by the W.B. Regarding the related negociations, disagreement is on the fertilizers issues. The W.B. would like to get the sector liberalised while for the government it is the symbol of its relations with the peasants given that there is no money to boost peasant agriculture as advocated by the government's policy. Further, the government has to account for the regions where fertilizers are used (Gojam, Shoa and Arssi). They are also some of these ones where there is a surplus of production. Therefore, it cannot deny the risk of increased output supply-shortage and local famine in the eventualities of fertilizers price liberalisation and/on Birr adjustment. Further, it has also to account for the impacts on fertilizers price of the transport deregulation by December 1992.

D - THE ECONOMIC POLICY OF THE TRANSITIONAL PERIOD (EPTP)

D.1 - THE POLITICAL CONTEXT

31. The government which has overthrown the DERG-regime has recognized that Ethiopia was in dire conditions by issuing documents on its **intentions** related to Ethiopia's Economic Policy during the Transitional Period. This one is defined to be the period (after the DERG-regime) characterized by the coalition of various forces (represented in the Council of

Representatives) around a common Charter which is the pillar of the transitional economic policy. It will cover the years 1991 to 1993 and end by announced free elections. The Charter has a major aim which is the strengthening of peace. Therefore, the EPTP final document has as main objective to stabilize the economy but departing from neutral political commitments. Moreover the document indicates that although being also designed to provide satisfactory solutions to urgent problems (the country rehabilitation, for instance, or the soldiers to demobilize and accomodate properly), the EPTP has to serve a longer period than the transitional one with minor changes. From an Ethiopian political view point neutrality will permit continuity. This one will then pave the way to democracy. With regard to economic rationality, the coalition resembles mainly marxist reformists and market ones. Further, at different top levels either the government or the State ones, there seems to have a lack of market culture. In short, the EPTP is first of all a compromise policy document. It carries with it major constraints these of relevancy versus political neutrality, market advocacy versus market understanding.

D.2 - THE CONTENT OF THE EPTP

32. The final EPTP document pleads for **market functioning in Ethiopia as the efficient solution to the country's challenges**. As a consequence, it indicates that :

(i) the role of the state in the investment decision process should be reduced at the opposite of that of the private sector and that of the state issuing market regulation and monitoring the economy as it is the case with market-based ones ;

(ii) people should be recognized rights to act as free traders. This in addition to democratic rights ;

(iii) enterprises whatever their owner is should be submitted to market rules i.e. the profitability, management autonomy and fair competition ones.

In the framework of numerous motives put forward to advocate state intervention in production etc..., for the present time, **the EPTP would lead to measures of implementation shaping the economy as a combination of public-based basic goods, services and financing and private sector-based food production, trade and distribution.** Although the private sector would be encouraged to participate in banking state ownership would remain in that key sector. The trade and transport (road) sectors where private initiative is strongly invited to take over would nevertheless "benefit" from a specific treatment, i.e. a regulation for the former, a new regulatory Authority for the latter. In any sector of the economy, private investment would remain to be approved at ministerial level. Also, to mention that in the case of all sectors where private initiative would prevail the State would favour the formation of co-operatives or associations on a voluntary basis, though. **Market advocacy leads to plead for state enterprises restructuration given the need to render these ones profitable.** But, in this framework too, there could be big exceptions which are banking and the industrial sector. Banking would remain state ownership to ensure banks would play their proper role in development while making profit. At the industry (plant) board level, workers would be given 30 per cent of the voting rights. In both cases, this could lead to conflicts of objectives reducing the operationality of the government's policy. In the case of industry, the government has clarified its position by issuing a new Labour Law. On the basis of it labour redundancy is now permitted although under limited conditions. Further, liberty to negociate is now recognized to trade and employers unions. Although, the document pleads for **market rights,** it does not advocate the change of the property rights in case of land (rural and urban) and 1975 nationalized houses. The first is a controversial issue between the North and the South of the country. It is delayed till the free elections. In the case of the second, compensation will be paid to those who deserve on the basis of appropriate studies. So, the late owners are not privileged compared to the actual tenants. No mention is made of what would occured to other 1975 nationalized assets.

33. **Through the state ownership in banking, the promotion of collective participation schemes, the regulation announced for the private trade and transport activities, the overseeing of ministeries on private investment, the number of motives put forward to advocate state intervention in production, private initiative although being praised remains very directly state regulated. Also to notice that most of the sectors which have been reserved for the state are non-existent at the present moment, however, the policy leaves the door open for such enterprises to be run as joint ventures in association with domestic or foreign private capital.** All this reflects likely political compromise.

34. **With regard to macro policy, the document advocates policies recommended by the World Bank.** For instance, **a monetary policy to ward off inflation, a fiscal one to achieve the control of the budget deficit, an open price** policy. Regarding sectoral potentials, the government indicates mainly intentions **of boosting peasant agriculture** by helping producers to receive fair prices for their produce and an easiest access to the needed input. It also advocates an **agricultural open market policy.** Privatization will be encouraged in accordance with the new investment code. The **Birr adjustment parity could be a controversial issue as banking between W.B. and the Ethiopian government.** The announced policy in the first case is that to permit a gradual adjustment in conjunction with the study of other alternatives. Up to now, the number of measures decided to implement the

EPTP is rather reduced this being likely due to political problems and therefore to the need to gain credit for the EPTP at the international level as financial support to it. On the basis of the decisions already taken **disagreements between the government and the business community** remain on : to decide to complete **the withdrawal of the State from the production,** etc... and as a result to open up **all activities to the private sector** i.e. **particularly, the banking one** ; to decide **the deregulation of the fertilizers system** and **the restitution of 1975 nationalized assets.**

D.3 - A SCRUTINITY OF THE EPTP

35. Although being politically pertinent for peace to be secured is the highest priority, and economically pertinent for market functioning is much more efficient than non-market one to tackle with the stabilization of a decentralized economy, **the EPTP lacks from relevancy** given Ethiopian present situation. Indeed, **it advocates the functioning of a market system while neglecting basic challenges to the Ethiopian economy and society** i.e. the riks to famine to reduce, poverty (and people's destitution) to alleviate, employment opportunities to create and the process of informalization to account for and **the market fundamental requirements** i.e. the availability in quantity and quality of production factors (assuming enough private saving and some production surplus). It does not either advocate an independent monetary authority to ease macro stabilization or the promotion of a private banking system to create a credit market policy, a feature of market-based economy. Apart from neglecting key factors, **the EPTP lacks also from relevancy to give the country a guidelines document for a real operational macro policy.** Indeed, its needs clarification on a lot of relevant issues. In the case of foreign capital, the government has already clarified its position by issuing a new investment code through which it appears that foreign capital as the domestic one is welcome in many activities.

36. To summarize all that preceeds : **during the transitional period (and over), the Ethiopian government has to encounter a lot of interacting major challenges, which would remain so for many years. In no way, growth expected to be grasped through a basic market economy can be thought robust and enough to soften sufficiently the challenges i.e. in people's current day living even when assuming a full implementation of the government's policy and should it be also fully relevant for the country. This pleads for actions internationally financed to help the country to recover.**

E - CONCLUSIONS

E.1 - EC'S MAIN FIELDS OF ACTION TO HELP ETHIOPIA TO RECOVER

37. In the light of the set of analysed documents, the EC's main fields of **urgent** actions should be to help Ethiopia **to focus on famine and employment.** This presumes a set of recommendations for policy to be implemented or modified on :

(i) **Agriculture and Poverty ;**

(ii) **Labour intensive sectors (such as construction, but not only) and informal activities.**

At **medium** and long term, recommendations should focus on :

(i) the need **to modify the legal framework** in accordance with market functioning but also accounting for market and government's failures within the economy ;

(ii) how **to restructure state industry** ;

(iii) how **to boost the private sector** ;

(iv) how **to get sustainable growth** ;

Before trying to detail relevant policies, it is worth indicating that the **EC should also recommend to the Ethiopian government to invite the Ethiopian business community to participate to discussions on policies to be implemented (or modified).** This would be an important step to reduce the credibility gap between the political and economical spheres, a key issue for growth. Growth being variously constrained, **policies specifically accounting for major constraints should also be recommended and financed both at short and medium run.** Here it has to be referred to **a plan helping to finance the expected budget deficit without creating further inflation.** Such a plan could not be postponed without important growth losses. How **to help Ethiopia to re-imbursh its external debt** has also to be referred to as to **which amount of food-aid is needed to help the country to become food-sufficient and to reduce risks to famine.** To finance a **study on a change to the Birr parity** could also be relevant for growth, but not only, for it could be also positive for the budget. To finance **a study on the inflation process** in Ethiopia would also be desirable.

38. It is not **now** likely to define the contents of recommended policies. Nevertheless, **some** measures have appeared to be relevant.

SHORT TERM

Famine (Agriculture, International food–aid, Poverty)

39. This is not an Ethiopian fatality. Indeed, it can be modified through a policy encompassing **measures to increase output supply**. At short run, measures could be :

– to increase prices really paid to the farmers ;
– to ensure peasants with the needed seeds during the following years ;
– to ensure peasants with some basic medical care ;
– to improve acces to water and draft power (animal one) ;
– to promote market spatial integration and more generally market liberalization ;
– to reduce taxation on peasants.

Even if the agriculture output supply policy succeeds, Ethiopia would not be food sufficient before many years. Indeed, the WB has indicated that to produce enough food for its population (3 per cent increase annually) Ethiopia should increase its agriculture production by 3.3 per cent on average during ten years without ceasing to import. This indicates that it is likely to assume **international food–aid at short and medium term** even in the case of drought disappearing and agriculture output supply policy succeeding. Famine is also a reflection of **poverty**. This would lead **to studies trying to identify why the Ethiopian peasant is so poor**. The studies should then lead to longer–term recommendations and actions to be internationally financed.

Employment (Labour intensive sectors, informal activities)

40. At short run, **measures should encounter the needs to restructure agriculture infrastructure and to restore or reconstruct urban dwellings using two factors of production the country can easily mobilize i.e. the ex–service men and the informal entrepreneurs. Measures should also encounter the wishes of the business community to increase labour market flexibility, to reduce the tax burden**. Measures could be :

– to launch a rural construction programme using soldiers who previously undertook infrastructure activities ;
– to give the informal entrepreneurs the burden to restore and reconstruct dwellings in urban areas ;
– to revise labour provisions to achieve firm–level flexibility in employment ;
– to reduce business taxation.

Indebtness, fiscal deficit and inflation

41. Urgent measures could be :

– to **soften** the external debt service payment through a negociated international agreement ;
– to **ensure** that the Russian claims do not receive Paris Club endorsement ;
– to **sell** some government–owned residential housing and smaller enterprises in the non-tradable sector, the amount guided by the need to stabilise the price level and/or to get funds ;
– to **sell** some rural lands without neglecting the impacts on rural income and migrations ;
– to **study** the impacts of a Birr adjustment parity. This issue is not only a controversial one between the government and the WB but also within the team assembled by DIAL. The WB does not really put pressures on the Ethiopian government to devaluate. It pushes it to provide other alternatives for it does not believe there are other alternatives. The government's investigation is costful. Indeed, the Ethiopian diaspora, mainly living in the US advocates the parity modification as a major condition to get rapatried funds. So, the Ethiopian government cannot neglect to carefully but also urgently investigate that issue ;
– to **study** the impacts (economic but not only) of a rural land market. The government has to avoid rural impoverishing processes and dramatic migrations before deciding to market rural lands. So, a careful investigation of this option is needed ;
– to **study** the roots of the inflation process (the budget, monetary overhang, etc...) in Ethiopia.

MEDIUM TERM

Legal framework, decentralisation

42. It is obvious to say that the legal framework has to be modified to fit democracy and market (for instance what sort of property rights to recommend) but that has to be carefully decided given the psychological impact on the whole society. Here too, studies are needed. This is also true regarding changes to decentralisation.

Industrial restructuration

43. Up to now, nobody knows with some economic rationality which industrial enterprises have to be restructured. The EC shoud therefore finance an auditing programme of action related to industrial activities. It should first determine which enterprises have to be closed down and what are their market price in case of private candidates willing to buy the related

enterprises. It should also illuminate what would be the social costs of such an adjustment. Second, it shoud define how restructure the rest of industrial enterprises.

The boosting of the peasantry, the private sector

44. Here measures should focus on :

- how to establish the **peasant cooperative societies as competing marketing channels** ;
- how to **facilitate livestock exports** by investment in marketing infrastructure ;
- how to establish **marketable water rights** in agriculture ;
- how to establish **communal rights** to regulate forests and similar agricultural common property ;
- how to **develop enterprises in formal activities** ;
- how to **integer informal entrepreneurs without prejudicing growth** by deciding constraining rules, etc..., related to informal activities.

In the case of the private sector a focus on **small-scale enterprises** is required. This pleads for measures :

(i) permitting these enterprises to develop ;
(ii) helping them not to remain limited to the production of labour intensive, low technology goods but to capture a niche in upscale segments of the market ;
(iii) helping them to export ;
(iv) removing price controls on industrial production ;
(v) permitting publicly owned banks to lend to private firms ;
(vi) promoting a private banking sector.

This later recommendation is a wish of the business community and the WB. Contrarily to what can be thought many positive effects can appear both on the **economic, social and financial fronts** what appears always desirable during difficult transition such as the Ethiopian one.

Inflation

45. Measures should be to increase labour productivity, mainly.

Financing

46. Measures could be :
- to establish a market in urban land ;

– to establish a market in government debt ;
– to promote a private banking sector ;
– to establish attractive savings instruments marketed in rural areas.

Sustainable growth

47. Here, it is pleaded for a development that meets the need of the present without compromising the ability of future generations to meet their needs. Policy focusing on (i) **Natural resources restoration and preservation** (NR) and (ii) **Poverty are at the core of the analysis in Ethiopia**. Regarding (i) this would lead the EC in agreement with Ethiopian Authorities to re–enforce its programme on soil restoration already implemented in Ethiopia and to define programme for reforestation, Ethiopia (Highlands) being one of the most degradated area in the world. Such an extended policy would really appear as a test–case of what can be done in other developing countries with analogous features. Indeed, very often, the plead for NR policy is accompanied by ponctual measures, only. Here the question would be what **policy (i.e. set of consistent interacting measures) for sustainability**. At long term policy for sustainability has to receive the highest priority in Ethiopia. So any EC's recommendations and/or actions at long run should be at its core. Regarding (ii) this would lead the EC to help the government to define a demographic policy consistent with people's aspirations, expected achievements and sustainability.

E.2 – BEYOND THE ETHIOPIAN TRANSITION : WHAT CAN BE GRASPED TO HELP OTHER DEVELOPING COUNTRIES TO PASS FROM CIVIL WAR AND COMMAND ECONOMY TO PEACE AND MARKET–BASED ONE

48. Up to now, the Ethiopian experiment has taught DIAL's staff that :

(i) credibility gap to reduce could matter more than rational policy (if any) to define. This is particularly true when there is a strong focus on past ideology and its results from one partner to the growth process ;

(ii) to plead for market economy is ambiguous. Indeed, partners have their own definitions which sometimes can conflict. So, to avoid some partners to participate to discussions on market is risky. That increases also the credibility gap ;

(iii) It is too early to indicate if there exists an Ethiopian transitional model. Indeed, further analysis and studies are needed. What can be said with a good level of probability is that in each country, there is a lot of conditions to be put in an hierarchical order to discover. More is not possible to say now.

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