# A QUESTION OF POWER: Why Ethiopia’s economic transformation is a cautionary African tale

Something is stirring in Ethiopia. It began with the abrupt resignation of former Prime Minister Hailemariam Desalegn on February 15. After weeks of backroom dealmaking the EPRDF coalition which has governed Ethiopia with an iron fist since ousting the Derg, Mengistu Haire Mariam’s Marxist dictatorship in 1991, elevated youthful Abiy Ahmed Ali as prime minister. The new prime minister hit the ground running with a raft of political reforms.

Three years ago, students in the town of Ambo started a protest to oppose a metropolitan development plan that would have incorporated their town and seven others into the capital, Addis Ababa. Ambo is 120 kilometres west of Addis in the Oromia region. They accused the federal government of a top-down land grab that would deprive them of livelihoods and destabilize their communities and culture.

After the overthrow of the Derg, Ethiopia adopted an ethno-federalist constitution that even provides for orderly secession. But the EPRDF has sought to run a command-and-control developmental state. The Addis Ababa expansion plan was a head-on-collision between the two—the constitution’s federalist ethno-regional political bargain and the centralizing ideology and power politics of the EPDRF. While the EPRDF is a consociational coalition, it’s the late strongman Meles Zenawi’s Tigrayan People’s Liberation Front (TPLF), which led the liberation war, that wields most of the power in the coalition (and gets most of the spoils). The Tigrayans are a relatively small tribe (six percent of the population) from the north of the country.

The Addis expansion plan, which affected the Oromo and Amhara regions, ignited discontent whose depth the EPDRF clearly underestimated. The Oromo are the largest ethnic group in Ethiopia, accounting for a third of Ethiopia's 100 million-strong population, with strong grievances of historic marginalization. The Amhara, who constitute just over a quarter of the population, are the erstwhile politically dominant ethnic group. Both Emperor Haile Selassie and Mengistu were Amhara (his father, originally Oromo, was adopted by an Amhara nobleman). Repression, including massacres, mass incarcerations and a state of emergency, a feature of both Emperor Selassie's late rule and Mengistu's Red Terror, returned under a beleaguered EPRDF.

Though unexpected, Desalegn's resignation was preceded by a softening of the regime, including the release of political prisoners, which Desalegn said was meant to "foster national reconciliation". The new prime minister is Oromo. His elevation was no doubt intended as an olive branch to the restive region.

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Hot on the heels of the tectonic shift in the politics have come equally momentous economic pronouncements. State owned Ethiopian Airlines and telecommunications and power utilities and other state corporations are to be partially privatized.

What exactly is cooking in Addis?

In his pronouncement speech, the Prime Minister Abiy spoke of a hard currency crisis. He is quoted in the media castigating his audience, Ethiopian businesspeople, for keeping their hard currency in Dubai and China and asking for their cooperation to resolve the crisis while also threatening unspecified actions on the hoarders of foreign exchange. Instructively, he also disclosed that the political crisis has dented diaspora remittances. Diaspora remittances are Ethiopia’s single largest source of foreign exchange, bringing in US$ 5.5 billion last year, almost double the country’s US$ 3 billion dollar export earnings.

The foreign exchange crisis is not new. In October last year, Ethiopia devalued the currency by 15 percent. While the recent government data shows foreign currency reserves equivalent to 2.3 months import requirements in December 2017, precarious but not dire (3-4 months requirements is the norm), some analysts say the reserves could have fallen below one month’s requirement, which is dire. Last week, the government announced that it had secured a US$1 billion foreign currency lifeline from the United Arab Emirates (UAE), part of a US$3billion aid and investment package. The UAE deal looks like a quid pro quo for Prime Minister Abiy’s de-escalation of tensions with Egypt over Ethiopia’s damming of the Blue Nile. The UAE is a strong ally of Egypt. This sequence of events begins to suggest that the foreign currency crunch is behind the softening of the EPDRF regime.

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Ethiopia has run into an old, mostly forgotten, economic development problem: the foreign exchange constraint. In the old days, it was caused by import substitution industrialisation. Import substitution industrialisation, the dominant development strategy for many sub-Saharan African states until the mid-seventies, entailed setting up industries to produce finished goods the country was importing, and protecting them from import competition with trade barriers, import and foreign exchange controls.

The new import substituting industries imported virtually everything from machinery, intermediate inputs, spare parts, technology and even management. The import substituting industry’s foreign exchange requirements ended up exceeding what the country was using to import the finished goods. Most of the import substitution industrializers relied on a few primary commodity exports. They soon found that their export earnings were insufficient to finance the industries.

Foreign exchange became scarce, and self-reinforcing. To circumvent foreign exchange rationing, businesses would hoard foreign exchange abroad through transfer pricing (over-invoicing imports and under-invoicing exports), compounding the primary motive for transfer pricing— tax evasion. One such scheme came to light not too long ago during the unravelling of the Nairobi Securities Exchange-listed corporate icon, CMC, which has since been delisted. It was revealed that the company had maintained a secret account in Jersey to which proceeds of over-invoicing were deposited and paid to its directors offshore. Remarkably, many of the beneficiaries of the scheme were the same bureaucrats who were responsible for enforcing foreign exchange controls.

The 1973 oil-shock and declining primary commodity prices in the ‘70s compounded the external imbalance that import substitution industrialization started. By the early ‘80s, most import substituting countries were on their knees. In some, Tanzania for example, manufacturing ground to a halt.

Ethiopia’s external imbalance and attendant foreign exchange crises emanate from over-investment in infrastructure. Ethiopia adopted an infrastructure-led growth strategy known as the Growth and Transformation Plan (GTP) in 2010. It has since doubled electricity generation from 1800 to 4200 MW, against peak power requirement of 2000 MW. There is close to 7,000MW of new power projects under construction. The Ethiopia Grand Renaissance dam alone has a capacity of 6450 MW. When these are completed, Ethiopia’s generation capacity will be more than four times domestic demand. The road network has been expanded two-and-a-half fold, from 44 km to 110 km of road per 1000 square kilometres. And there is of course the 670-km Addis-Djibouti railway, and a light rail system for Addis Ababa, operational since late 2015 .

The infrastructure building boom, described in a recent World Bank report as “one of the highest rates of public investment in the world”, turbocharged Ethiopia’s economic growth rate from a respectable 5-6 percent to an exceptional 10 percent per year. But close to a decade on, the anticipated private investment that would enable Ethiopia to pay for it has not materialised. Ethiopia was banking on export processing zones investment, and has built several industrial parks around the country.

Besides failing to attract investment, building booms of this magnitude have the effect of shifting incentives against “tradable” sectors of the economy. This phenomenon is more commonly associated with natural resource booms that economists call Dutch Disease. This is reflected in the decline of Ethiopia’s export to GDP ratio, from 17 percent to eight percent of GDP compared to Sub-Saharan average of 27 percent. Its export to GDP ratio is now the second lowest on the sub-continent after Burundi (6.2%).

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Sugar Corporation is currently developing ten large-scale sugar projects that will put a million acres of land under sugarcane production. A capital intensive, low value product with distorted markets and a permanent global glut floating in the high seas, sugar is as bad as import substitution industries get. Yet there is no shortage of export-oriented agriculture investments Ethiopia could have chosen. Oilseeds are Ethiopia's second largest export earner after coffee. It has a promising livestock and leather apparel industry. Maize even.

The Bretton Woods institutions spent the '80s and '90s preaching the free market economic orthodoxy known as the Washington Consensus. Ethiopia has done the complete opposite. But the World Bank has been nothing but effusive. In a 2016 report, *Ethiopia's Great Run: The Growth Acceleration and How to Pace it*, the World Bank asserts confidently that Ethiopia was on course to become a middle income country by 2025. Astoundingly the World Bank goes ahead to give a thumbs up to the policy regime that its structural adjustment programmes (SAPs) dismantled:

"Heterodox financing arrangements supported one of the highest public investment rates in the world. 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."

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Heterodox means unorthodox or unconventional. In plain English, it means distorting credit markets, overvaluing the currency and printing money.

After all the cheerleading, the Bretton Woods sisters now find themselves in an awkward situation. In its most recent debt sustainability report, the IMF acknowledges that Ethiopia is now staring at a debt crisis. It has no advice to give. Ethiopia’s hopes, it writes, now rest on exporting electricity. The IMF posits that Ethiopia has the potential to earn US$ 1 billion a year from selling electricity.

In reality, Ethiopia is selling a little power to Sudan and Djibouti, and has signed power purchase agreements with Kenya and Tanzania. But these countries are ramping up their own generation capacity. Kenya’s installed capacity is presently 35 percent above peak generation requirements excluding the 340 MW Turkana wind power which is awaiting completion of a transmission line, 55 percent when it is included. There are several other projects underway, and Kenya’s government seems dead set on proceeding with a controversial 1000MW coal plant in Lamu. Ditto Tanzania.

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Ethiopia’s biggest electricity customer potentially is Egypt. This may begin to explain the reason for the olive branch. Prime Minister Abiy also made a quick visit to Somalia last week. He might be hoping to sell some electricity there. To flog a billion dollars worth of power, Ethiopia will need to make peace with all her neighbours, and then some. If truth be told, the electricity export bonanza is a fig leaf.

There is a cold reality that the Ethiopian government seems to be still in denial about. Its heterodox macroeconomic regime is now untenable Investors do not like putting their money in places where it is difficult to get out. And now that people know how precarious the situation is, hard currency hoarding and capital flight will get worse, not better.

The competing destinations for the export processing investment that Ethiopia is building industrial parks for do not have exchange controls. And Ethiopia has many disadvantages to overcome, not least, being landlocked, not to mention its byzantine bureaucracy and anti-capitalist instinct. Financial liberalisation is inevitable, a matter of when and how, not if. The Prime Minister talked of the foreign exchange problem being a long term problem. He is dead wrong. He has eighteen months—best case scenario. His options boil down to whether to do big bang or gradual – rather like choosing whether to do your root canals all at once or every other week.

The announced fire sale of family silver will not do it either. Deregulation should precede privatisation otherwise it substitutes public monopolies for private ones. In the case of the telecom monopoly in particular, deregulation will kill a whole flock of birds with one stone—bring in hard currency from license fees, investment, access (at 40% Ethiopia's mobile penetration is the lowest in the region) and quality of services. The sugar factories I would sell right away on an "as-is-where-is" basis. A stitch in time saves nine.

Ethiopia is by no means the only country floundering on infrastructure-led growth. It is a foolish idea. Monuments, delusions of grandeur, cargo cults—this columnist has all but run out of metaphors. Last year, Zambia's President called a national day of prayer for the Kwacha. Last week he suspended borrowing and instituted an austerity programme that includes freezing projects that are less than 80 percent complete. Kenya is surviving on speculative capital inflows and juggling debt as it negotiates an IMF bailout.

Ethiopia's unravelling is a reflection of its macroeconomic policy regime. When demand and supply don't balance, something must give. In a liberal regime it is prices that adjust (exchange rate, interest, and inflation). If prices are controlled then demand or supply must give, in this case, the supply of foreign exchange. Still, the crisis has provided an opportunity for transformational political and economic change. To quote economist Paul Romer, a crisis is a terrible thing to waste.