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   HYPOTHESES

   RESEARCH METHODOLOGY

   RESULTS & DISCUSSION

   FINDINGS

   RECOMMENDATIONS/SUGGESTIONS

   CONCLUSIONS

   SCOPE FOR FURTHER RESEARCH

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   APPENDIX/ANNEXURE

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THE EFFECT OF CURRENCY DEVALUATION ON THE ETHIOPIAN ECONOMY'S TRADE BALANCE: A TIME SERIOUS ANALAYSIS

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ABSTRACT

Numbers of studies have shown that devaluation of host economy currency improves trade balance of that economy. The study focused on analyzing the effect of Birr devaluation on trade balance of Ethiopian economy using 30 years of time serious data. Results were based on secondary data collected from national macroeconomic institutions. Descriptive statistics and regression analysis were employed as analytical tools. The descriptive method dealt to glance the trend and structure of Ethiopian imports and exports before and after currency devaluation and result typified that trade balance had been deficit consistently. The regression analysis was used to look at the determinants of trade balance (proxy current account balance). Accordingly, real GDP and Real Effective Exchange Rate Index were positively correlated with the nation's trade balance while currency devaluation was negatively correlated with trade balance. The recommendations raised from the study were that there was a need to introduce import substitutions and export oriented strategy of industrialization scheme so as to improve the country's competitiveness on the external world. More so, there should be provision of infrastructural facilities and subsidies to the export sector of the economy particularly to agriculture.

KEYWORDS

Trade Balance, Currency Devaluation, OLS, Ethiopia.

INTRODUCTION

The global economy had passed through different macroeconomic instabilities which have hindered the pace of economic development. In such problems, most nations have been facing a problem of unfortunate decision to embark upon the existed economic problem(Berg, 2001).Moreover, LDCs typically Africa also had suffered from those macroeconomic problems and the situation has been horrific for the last four-five decades. The continuing macroeconomic crisis has several dimensions running from negative economic growth, serious reduction in Bop and fiscal policy problems, sluggish agricultural performance and foreign exchange performance which have been triggered for currency devaluation. Likewise, Ethiopia's macroeconomic performance also undermined and seriously affected by these instabilities.

In this occasion, like most SSA countries, Ethiopia's economy was subjected to external sector which comprises both import and export sectors. During the military regime, Ethiopia's external sector enormously affected by current account deficit due to stagnant export earnings and rising imports(World Bank,1990). From the year 1988/89 up to 1990/91 export earnings were declined from Birr 902.8 million to Birr 616.4 million, while import expenditure rosé from Birr 2110.4 million to 2130.4 Birr million (NBE, 2003/04). As most findings pointed out that, one of the causes for this problem was the exchange rate policy, i.e,. Overvaluation of the domestic currency taken by the military government. In those periods, Birr had been pegged to the US Dollar at a constant exchange rate, $1= 2.07 Birr. Unlike to the Derg regime, Transitional Government of Ethiopia (TGE) has undertaken an economic reform program by designing new economic policies and map out economic development strategies for stimulating external balance. The devaluation of Birr was one of the corrective measures for combating current account .On 1992; TGE had devalued Birr by 58.6% i.e. from Birr 2.07 to 5.00 per .

On the top of this, the country's economic performance was ignited and had tried to register better outcomes on the external economy (trade balance). Ethiopian economy basically on trade balance has been discussed in an attempt to show whether the post devaluation situation has exhibited healthy external sector and trade balance. More specifically, the paper tried to answer the fundamental issues like to examine the impact of devaluation on the Ethiopian import, export and trade balance.

CONCEPTUAL FRAME WORK

Currency devaluation is defined as a deliberate decision made by the government to reduce the value of its own currency in relation to the currencies of other countries (Newman, 1999).In most cases, currency devaluation was often used interchangeably with depreciation but they are quite different. As stated above, devaluation is a deliberate action taken by the concerned authority and it is mostly practiced in fixed exchange rate regime. While, depreciation is a gradual decrement in the price of domestic currency in relation to foreign currency determined by the market forces and it can be practiced by any exchange rate regime (Krugman, 2006).According to the 'Orthodox economic theory' devaluation is expected to have an expenditure switching from foreign to domestic goods and an expenditure reducing on foreign products. Both effects work to improve the current account position of a country by making imports relatively more expensive and exports cheap. In addition, supplementary export sales provided an injection of spending in to the economy which encouraged additional production and reduced the level of unemployment. However, devaluation may create some inflationary pressures in the host country by decreasing the purchasing power of the currency.

Currency devaluation was often associated with developing countries that do not allow their currency prices to float on the open market. And the stabilization or adjustment policies usually advocated by the IMF for LDCs, BOP instability occurrence because of a sharp fall in terms of trade. Therefore, vast LDCs governments have devalued their currency for promoting the external sector and reducing trade deficit. Unfortunately, even if there is some advancement in the volume of trade, particularly SSAs cannot alter their trade balance rather the situation was aggravated (Ghatak, 1994). For these reason, international institutions like IMF and World Bank are attracted by this issue and continuously give affirmative action and policy reformations. The paper has organized as fellow. The first part signaled about the introduction of the overall study pertaining to the subject matter. Secondly, dealt about the conceptual frame work. Thirdly it amplified the methodologies that the study has employed to give a scientific analysis and stressed on results of the study and its discussion. Final, the paper has made conclusion and point out some possible recommendations.

MATERIALS AND METHODS

DATA SOURCE

The paper employed secondary time series data which were collected from the National Bank of Ethiopia (NBE), Ministry of Economic Development and Corporation (MEDAC) of 30 conomic years.

MODEL SPECIFICATION

So as to show the impact of currency devaluation on Ethiopian trade balance, OLS method of estimation was employed as fellow. Trade balance was considered as dependent variable influenced by set of explanatory variables like RGDP, REERI, and Currency Devaluation i.e. the policy dummy and the error term.

$$TB_t = \alpha_0 + \beta_1 Currdeval_t + \beta_2 RGDP_t + \beta_3 REERI_t + Ut \quad (1)$$

Where:

TBt	=	Trade Balance
Curdevalt	=	Currency Devaluation
	=	0 Pre devaluation
	=	1 Post devaluation
RGDPt	=	Real Gross Domestic Product
REERIt	=	Real Effective Exchange Rate Index
U_t	=	Random disturbance (error) term

DEFINTION OF VARIABLES

TRADE BALANCE: is the difference between the value of merchandize export and value of merchandize import per time.

REAL GROSS DOMESTIC PRODUCT: is the monetary value of country's domestic production usually in a calendar year which is adjusted for inflation.

CURRENCY DEVALUATION: is a kind of policy measure which makes the domestic currency to have lower value in relative to foreign currency in order to forward possible advancements to the external sector.

REAL EFFECTIVE EXCHANGE RATE INDEX: is an index which is obtained by deflating the nominal effective exchange rate (a measure of the value of currency against a weighted average of several foreign currencies) by suitable effective deflator.

DATA DESCRIPTION, RESULTS AND DISCUSSION

DESCRIPTIVE ANALYSIS

In this sub section, the paper tried to look the trend and structure of Ethiopian imports and exports descriptively. In accordance with the objective of the study, it would be showed in two time horizons vis-à-vis pre-devaluation and post-devaluation periods. Ethiopian foreign trade had been travelled on the road of trade deficit. Even if there are various reasons behind the chronic deficit, currency overvaluation was the dominant one. During the military regime Birr was pegged to 2.07 per USD which could be characterized as overvalued exchange rate. Thus, to overcome the deficit, in the late 1992 EPRDF had devalued the exchange rate to Birr 5 per USD which was intended to boost exports and discourage imports.

Ethiopian merchandize external sector has been doing much more transactions. Some of them are part of generating revenue, exports, and they are regarded as expenditures, imports. So, the trend of these two macroeconomic variables showed different connotations as a result of the policy measures taken by the government. Table 1 shown below comprised the trend of value of imports and exports.

TABLE 1: THE VALUE OF IMPORTS AND EXPORTS AND THEIR GROWTH RATES *(in millions birr)*

Year G.C.	*Export (A)*	*Imports (B)*	*Growth rate of A (%)*	*Growth rate of B (%)*
1988/89	902.8	2110.4	---	---
1989/90	736.8	1832.3	-18.4	-13.1
1990/91	614.4	2130.4	-16.6	16.2
1991/92	318.4	1810.9	-48.3	-14.9
1992/93	949.0	3618.8	19.8	99.8
1993/94	1419.5	4740.3	49.5	31.0
1994/95	2835.2	6546.3	99.7	38.1

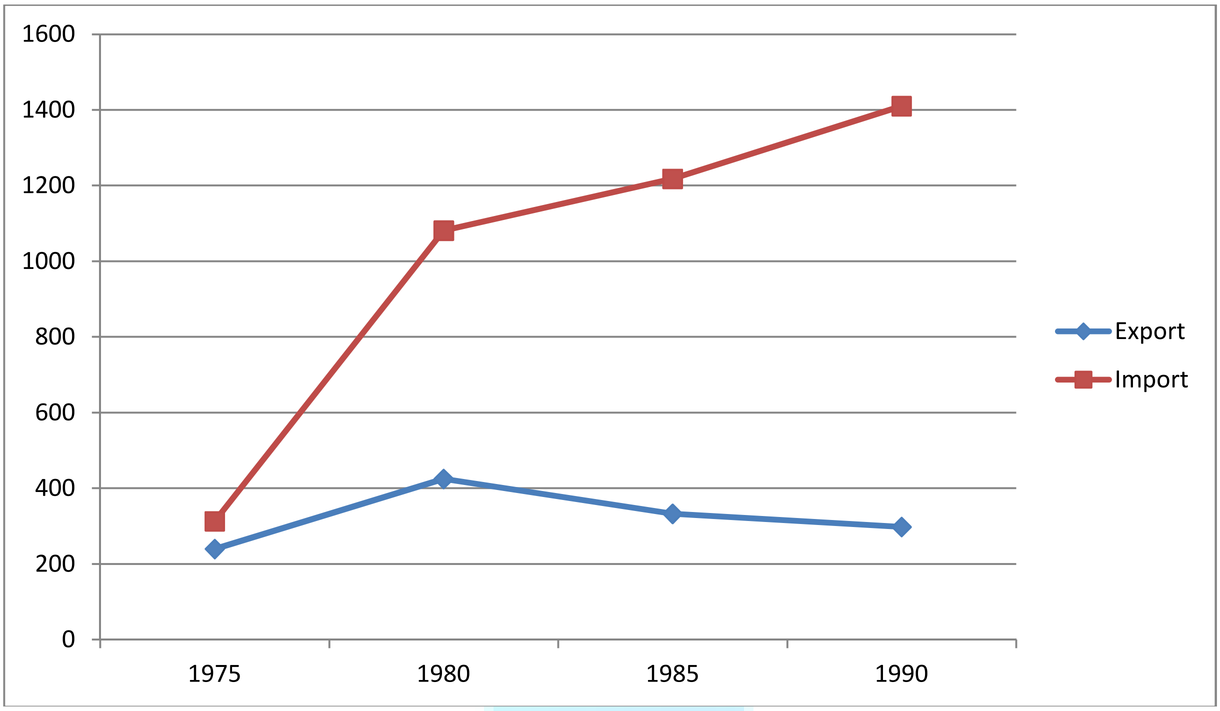
Source: NBE, 2003/04

As shown in the above Table 1, on the one hand, during the years before devaluation (1992) the growth rate of exports was negative i.e. declining trend. There are many factors that affected this declining performance of Ethiopian exports. Firstly, the exchange rate was overvalued which made the country's export relatively very expensive induced low export earnings. Secondly, the emergency of parallel exchange market due to misalignment exchange rate which has stimulated the smuggling exports. It was more profitable for exporters to exchange foreign by domestic currency in the parallel market which paid high premium

After the devaluation of Birr in 1992, the foreign earnings from export started to increase. As indicated in the above Table 1., by the year of 1992/93 the growth rate of exports had reached 19.8% and this trend has continued to the years 1993/94 and 1994/95 with a 49.5% and 99.7% growth rates respectively. As a result of currency devaluation, the commodities which priory had subjected to domestic consumption could be re-channeled to international market through exports and accelerate the export earnings of the country.

Pre devaluation period, the major exports of Ethiopia were agricultural products like coffee, hide and skins, chat and live animals have contributed large shares even though coffee was the dominant one. Notwithstanding the exports, the country mainly imported raw materials, semi finished goods, fuel, capital and consumer goods. Generally speaking, before devaluation of Birr, Ethiopia's import outweighs its exports by far distant as shown in figure below.

FIGURE 1: TREND OF ETHIOPIAN FOREIGN TRADE



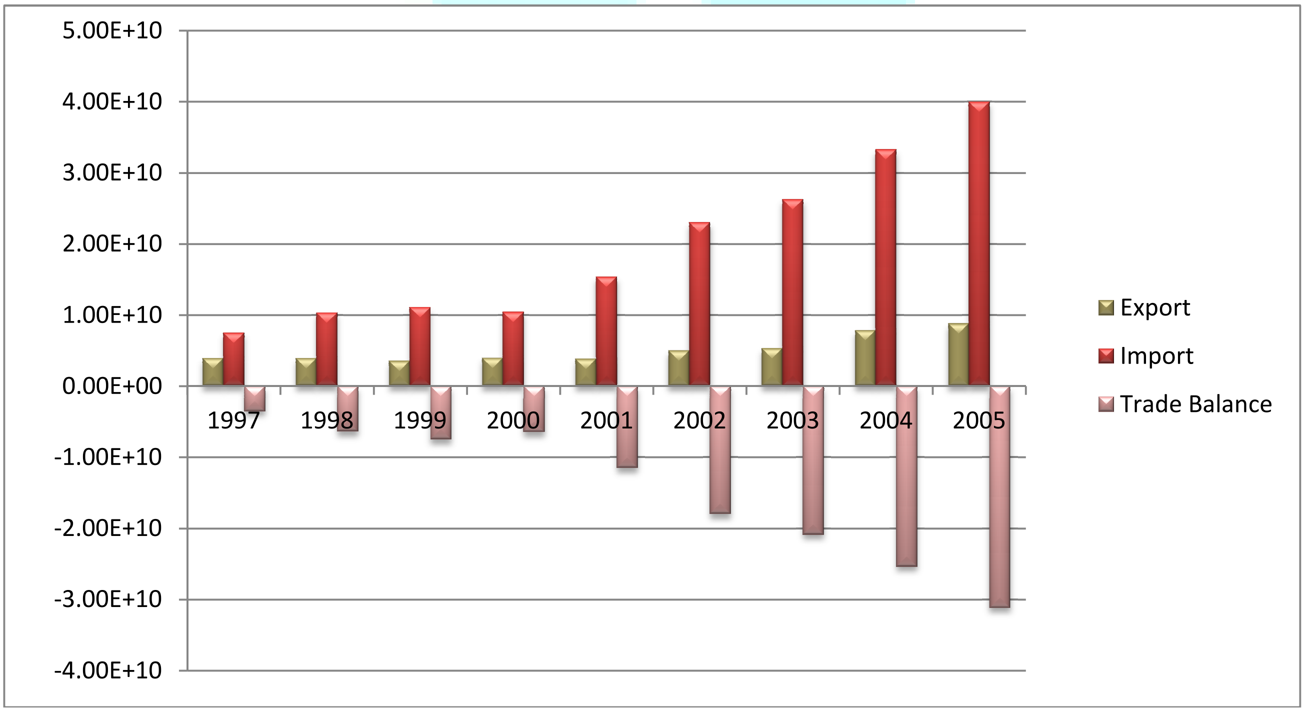
Source: IMF, International Financial Statistics Year Book, 1999.

As shown in the above Figure 1 , the value of exports had increased sharply between the years 1975-1980 .While, after 1980the value of exports became declining. As a result of inappropriate monetary policy and rigid economic system, the gap between imports and exports continuously increased, and confined with chronic trade deficit.

Like the pre-devaluation periods, the leading export products of the country after devaluation were coffee, oil seeds, pulses and spices, chat, hides and skins; and in very recent years horticulture products and gold. During the 1994/95, the share of the biggest contributors to the export earnings of the country was as follows: coffee (63%), oil seeds (2%), hides and skins (13%), pulses (4%), chat (6%) and gold (4%). One can also observe from the Table 2 that the values of exports were very low at the beginning of the reform year, 1992/93. Since the reform period, there has been an imperative improvement in the export composition. Even though the sector was still dominated by a few primary products and coffee has taken the biggest foreign exchange source, its percentage contribution to export earnings has gradually declined from 59% on average during the1992/93-95/96 period to 33% between the years 2005/06-08/09. This phenomenon was occurred not only due to the value of the coffee earning has declined but also other sectors' products to export earnings have increased.

Similarly, the import structure has also effectively increased in relative terms. In fact, imports have increased in value more than the value of exports, which contributed to the worsening of trade balance. Ethiopia has experienced a chronic trade deficit although it devalued its currency which aimed to bolster the merchandize export above import. The following figure showed the merchandize trade and its balance in the post-devaluation periods.

FIGURE 2: MERCHANDIZE TRADE AND ITS BALANCE



Source: Ethiopian Customs Authority, 2006.

In a nutshell, the diagram revealed that after the devaluation periods merchandize export earnings have still fallen short of covering even half of the import bill. Generally speaking, like in the case of the pre-devaluation period, here in the post devaluation periods the trade balances could not be improved rather the situation became worsen.

ECONOMETRIC ANALYSIS

Multivariate econometric analysis helps us to identify factors influencing the extent of trade balance. To that end, we exploit OLS model. But a head of discussion, we invest much on the post estimation robustness checking. Problem of non -stationary was tested using unit root test of stationarity via Augmented Dickey-Fuller (ADF) as the nature of the data is time serious which could have a problem of economic and statistical implication. For that end, the results described that all the selected variables at all level of significance were non stationary. In a sense that, their computed ADF value of each variables greater than the critical values at 1% and 5%. This implied that the probability distribution of those variables didn't change in the specified time path. To overcome the problem of heteroskedasticity, robust standard estimation method was adopted. Simple correlation coefficient matrix was done in order to test whether multicollinearity was present or not among the explanatory variables. For that matter correlation matrix results were less than 0.8 and Variation Inflation Factor (VIF) was less than 10 .Tests for autocorrelation have applied and, Durbin- Watson first order serial correlation test was employed and result was laid with 4-dL (2.988) was greater than du (1.74, and 1.63) at 10%, and 5% level of significance respectively. The P- value assured the tail probability for the two tail test for rejecting of the null hypothesis over the level of significance (i.e., 95% CI) of slope coefficients of each variable. The F-value, 96.56, showed that the overall model for the estimates of the OLS regression as a good fit. The fit of the model was good with R-square 0.96.

DISCUSSION

Largely in all cases, the statistical significance of the various parameters differs widely across variables and the signs of the estimated variables are as anticipated with reasonable relative magnitudes. As it can be seen from the results of the regression model, the Ordinary Least Square regression result which included estimation of the parameters for the linear-linear relationships of the variables:

TB= -36082.14 - 4610.133Curdeval + 0.682RGDP + 38.21191REERI

(4688.173)* (1439.108) (0.0554165) (13.89788)

R^2= 0.9644 n=30 F(3, 26) = 96.56 Pr> F = 0.0000

The proportion of variation of the dependent variable was well explained by those three independent variables. The explanatory variables, RGDP and REERI, affected the trade balance positively. The marginal effect of the variable RGDP indicated that RGDP increased by one million Birr, the value of trade balance would has increased by .68 million Birr *citrus Paribas*. Similarly, when REERI increased by one percent, the value of trade balance of tends to increase by 38.21 million Birr. In contrast, currency devaluation affected the trade balance negatively. The marginal effect revealed that when the host country adopted the policy measure, devaluation of Birr, it would widen the gap between export and import and aggravated trade deficit. This result was quite consistent with the study made by Girma (2005) revealed that currency devaluation inhibited the balance of trade of Ethiopia even though it could enable the export sector to increase by volume and value.

SUMMARY OF MAJOR FINDINGS

This study focused on examining the effect of currency devaluation Ethiopian trade balance using 1989-2008 data. On an overall, the findings of this study revealed that:

The finding has figured out that in Ethiopia currency devaluation balance of trade. The intension for implementing currency devaluation policy was to boost the merchandize export over merchandize import even though the trade balance had deteriorated after devaluation. This was mainly due to the high demand elasticity for imported items with supply inelasticity of Ethiopia's export goods. The econometric result of this study indicated that although there was significant positive relationship between trade balance and RGDP and REERI, currency devaluation has a significant inverse relationship with that of trade balance. In a sense, devaluation failed to improve Ethiopia's balance of trade. Furthermore, in common parlance, the study found out that though the value of exports had been increased in the years after devaluation of Birr, it was insufficient to offset the tremendous increment of imports.

RECOMMENDATIONS

1. From the foregoing discussion, in a plain language, Ethiopian trade balance was influenced by the four macro variables. It may safely to recommend that Ethiopian trade balance was in a good position for all positive value of the variables except the dummy devaluation. Therefore**,** supporting the export oriented sectors so as to improve earning from the export and in turn to improve trade balance.
2. Even though the current trade balance is deficit from the outweigh of import to export, still then best alternative to overcome the deficit is through continuous devaluation domestic currency(Birr) in the long run may be effective enough to support the trade balance.
3. Promote import substitution strategy by subsidies to or lessening the tax rate paid by the domestic industries to substitute their imported inputs.

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