The Causes of the Current Ethiopian Soaring Inflation Rate: A Non-Technical Analysis
By Dr.Seid Hassan

The most significant and daunting problem facing Ethiopia today is the rampant inflation rate. As reported by bloomberg.com, the Ethiopian Statistical Agency has reported that inflation for March 2008 has risen to 29.6%, food price inflation being even higher (39.4%). Some reports indicate the inflation rate in January 2008 to be in the range of 36%. According to Prime Minister Meles Zenawi, the causes of this rampant inflation rate are a growing economy, greedy merchants, and/or farmers who happen to demand higher prices for their products or an increase in demand.

Let us use both economic theory and the facts on the ground to scrutinize the statements made by the Prime Minister. According to many reports, Prime Minister Meles Zenawi has suggested to the Ethiopian parliamentarians that the current rampant inflation rate can in part be associated with the current rise in the Ethiopian economy. By this, he probably meant to suggest that the rising inflation rate is partially caused by an increase in demand- a concept related to the so-called demand-pull inflation[i]. If that is what he meant, the explanation he tried to give is either mechanical or a result of a misunderstanding of the concept of demand-pull inflation or due to a disingenuous misrepresentation of the facts. His statements could be construed as being mechanical and a lack of an understanding of the concept of demand-pull inflation because he might has been just shifting the demand curve without knowing the factors that shift it. To begin with, a demand-pull inflation is ***gradual in nature*** and it is mainly caused by ***continuous government spending***. Government spending might indeed has played a role in the rising Ethiopian inflation rate but, as I will show below, it is not the main cause of this fast and rampant inflation rate. If the Prime Minister is to tell us that the rampant inflation rate is caused by a growing economy and an increased demand, we should observe reductions in the unemployment rate in the country. Unfortunately, not only we do not see any reduction of the unemployment rate, but the unemployment rate must be embarrassingly so high that the government does not even want to tell us what it is! Moreover, if the increased demand is caused by higher demand for the goods and services produced by individual firms, the same firms, faced with such higher prices, must be paying higher wage rates to attract more workers. Of course, what one observes in Ethiopia is not increasing wages, but hungry people running around the major cities trying to make for the day! If firms were indeed paying higher wage rates, the same higher wage rates would have increased the cost of production (decrease supply) thereby offsetting the increase in demand. A rise in the cost of production (decrease in supply) exacerbate the inflation rate and may even play a role for the economy to contract! In any case, the rampant inflation rate- being caused by a rising demand – which necessitates a rise in real wages, is ruled out since the facts on the ground suggests otherwise.

It is also reported that Mr. Zenawi told the Ethiopian parliamentarians that the now “free and independent Ethiopian peasantry”, which is asking higher prices for its produce is to blame for the rampant inflation rate that is taking place in the country. If, indeed, the Ethiopian peasants are asking higher prices for their outputs, these same higher prices ***must induce them*** to produce more and bring more to the market. The higher outputs should increase supply and reduce the price of agricultural outputs. In short, the increase in demand should be ***completely offset*** by the increase in supply; hence, there should not be any significant changes in prices. This, of course, is not the case as far as Ethiopia is concerned.

In fact, this is not the first time that Mr. Zenawi deceptively used the millions of destitute Ethiopian peasants to his political advantage. As Ato Kahsay Berhe in his 2005 book aptly put it, all that Meles Zenawi has done, beginning in the 1970s, is control the socioeconomic life of the peasantry (see pp. 74-76). Not only is Meles Zenwi controlling the life of the peasantry, but his party has also been extorting the peasantry by levying its exorbitant and exploitative fees on fertilizers. By doing so, his party has been acting like leeches, bed bugs, lice, and the mujelie – all of them combined- shamelessly sucking up the bloods of the poor peasants from top to bottom! To add insult to all of these injuries, Mr. Zenawi now tell us that the Ethiopian peasants are now free enough to demand higher prices for their produce! The fact of the matter is that, by not privatizing land, the Meles government is committing despicable ***crimes against humanity***. By not privatizing land, the government is using land to continue ***terrorizing*** the peasantry and holding them ***hostage*** in their own country. By not privatizing land, the government has denied the peasants from ***creating capital*** using their own land as collateral. By not privatizing land, the government has pushed the peasants to be less careful about, the impact of overgrazing, soil and wind erosion that has engulfed the country. The current land tenure system falsely guaranteed land to every peasant. Such false guarantees ***encourage increased fertility***. The fact of the matter is that these ridiculous policies have condemned nearly 85% of the population to be more destitute, forget about them being so rich and free! The fact of the matter is that, as the weekly *Addis Fortune* magazine on its May 20, 2007 edition aptly put it, ***farm productivity has declined leading the Ethiopian peasants into increased poverty***! Sadly, when some parliamentarians kindly tried to indicate to the Prime Minister that the Ethiopian peasants are faced with increased hardships and even starvation, and not getting really richer than before, he followed it up with the usual deflection and his threats.

Unfortunately, the negative impact of all of TPLF's bad policies would be felt for many generations to come, some of the lost resources being unrecoverable. How can Ethiopia bring back the soil that goes to the Mediterranean Sea, for example? Can Ethiopia bring back the soil that is being swept for desertification and wind erosion? How can our Motherland bring the lives of those peasants whose lives are cut short because of the insufficient nutrition brought about by the bad policies of the TPLF?

The causes of the rampant inflation rate in Ethiopia- A Dummy's Guide

1. ***Increase in the money supply***. As anyone who has taken baby Economics 101 understands, the cost of printing a $100.00 bill is less than $0.25 (with an apparent profit of at least $99.75 going to those who print the money!) The same analogy applies to the Ethiopian case. It is clear from this that there is a strong and built-in ***temptation*** to print more and finance a government's budget deficit through the creation of money. Economic history also indicates that ***weak and corrupt*** governments tend to finance their expenditures by borrowing and monetizing the debt. As far as Ethiopia is concerned, the IMF has reported that the broad money supply in Ethiopia has been growing relatively fast in recent years. The excess reserves that the entire banking system has faced with also indicate that the system is flooded with cash, among other things. This stealth way of financing government spending and party owned parastatals is dangerous and is an ***outright theft of the public***. We are not even mentioning the daily street talk that fake money being circulated within the country. In any case, the increase in the money supply leads to 'too many birr chasing too few goods' - resulting in high inflation rates. This is one of the causes of the rampant Ethiopian inflation rate.
2. ***The low interest rates (and negative real interest rates)*** - It has been reported that

interest rates in Ethiopia are unacceptably low being in the range of 8-10%. On the other hand, the country is faced with a rampant inflation rate, some indicating it to be about 36%. Assuming that it is 29.6%, as recently reported by Bloomberg.com, the real interest rate (the interest rate adjusted for inflation) is -20% (negative) or more. In nonprofessional terms, this means that, if, for example, I am a borrower and you are a lender, ***you pay me 20% to use your assets***! You can see how ***addictive*** I would be to such an unfair payoff! Such negative interest rates ***redistribute*** income and assets from the lenders (savers) to the borrowers! Given the fact that most of the borrowers and the ones who have access to the savings, by hook or crook, are TPLF owned companies (parastatals) and its cadres, they will continue to do everything in their power to exploit the poor savers! Such an excessive borrowing by party parastatals, known as cronyism, is also dangerous and may lead to a financial crisis, a concept briefly discussed below.

3. ***Soaring oil prices***: The Voice of America one time (early 2008) reported that close to 96% of the foreign exchange earnings of the country is spent on oil imports. The soaring oil prices affect the cost of production in a negative way thereby decreasing the supply of goods and services. The electricity outages and blackouts in the country will continue to affect the overall growth of the economy, in addition to making the consumer to suffer. How in the world Ethiopia, which nearly spends all of its foreign exchange earnings on oil imports, finds economic growth from soaring oil prices, Mr. Prime Minister? How many Ethiopians do you think would be hoodwinked when someone tells them the economy is growing while food is being rationed at the same time? The fact of the matter is that the soaring oil prices are affecting the growth of all non-oil producing countries, let alone a country that is pending all of its export earnings on oil imports!

4. ***Increase in money supply from abroad***: Many reports indicate that between 35% and 40% of the Ethiopian government budget is financed through the so-called economic aid and ODA (Official Development Assistance). The huge volume of foreign money entering the country bolsters the demand for goods and services, and as a result increases the risk of inflation unless their impact is thwarted by raising interest rates on treasury bills to ease their inflationary pressures. When a government receives the assistance in foreign currency, these foreign reserves are then spent on imported goods and services, or exchanged for funds in the national currency. To be honest, the inflationary effects of loans or aid are weak compared to the increase in the domestic money supply but if the aid is large and continuous, as is the case for Ethiopia, they add to the scenario of "too many dollars chasing too few goods." This inflationary cost adds to the costs of foreign aid, both practical and psychological- both of which have lasting and damaging effects on a country. If, in fact, foreign aid were that good, many borrowing nations, including Ethiopia would have developed by now. Many experts, such as William Easterly, Kenneth Rogoff and others have argued, quite convincingly, that the empirical evidence indicating that counties developed using foreign aid is either nonexistent or thin. Incredibly, this writer has observed, on many occasions, the TPLF –through its highly controlled media and its cadres and supporters- boasting about its *special relationships* with the lending agencies!

5. ***War Expenditures***: In general, governments finance their wars by borrowing and printing money, rather than presenting a bill to the legislatures directly in the form of

higher taxes. This is especially the case if the ***tax-base*** is rather weak and/or the government in question does not have the support of its people. As we all know, the Ethiopian government has invaded a neighboring country. It is also at odds with its own people after it has stolen their votes after the 2005 election. The government is spending huge sums of money to crack down descent and to pay for those who are loyal to it. In addition, it is conducting the no-war-no-peace policy with neighboring Eritrea. Were it not for its invasion of Somalia – which might have severely broken its military power, and were it not for a lack of public support for the government, it would have been at war with Eritrea by now. For, creating unnecessary wars is in the nature dictatorial and despotic regimes like the TPLF! In fact, it is quite possible for the TPLF to restart the war with Eritrea whenever it wants to deflect its difficulties at home or whenever it feels that it has a backing from its superpower masters. History reveals that, as a surrogate to the United States and Britain, the TPLF regime is known to instigate conflicts with every neighboring country except Kenya. The Eritrean regime, despotic just like its Ethiopian contemporary adversary, may be the one who could instigate the conflict. At this point time, however, the regime in Eritrea should be quite content with its contemporary adversary in Addis Ababa being tied up in Somalia. Isayas Afewerqi should also be content with his role of adding more fuel to the fire by supporting the disaffected ethnic groups within Ethiopia, some of them working for the destruction of Ethiopia, which has been the strategic policy of Mr. Afewerqi from the get go.

In any case, the regime in Addis Ababa is spending huge sums of money to feed, transport, and arm the hundreds of thousands of its soldiers, in Somalia, stationed at the borders with Eritrea, and those Agazi killing squads who go around the country to suppress decent. These war expenditures add more to the existing shortages and inflationary pressures. The inflationary costs, whether the wars are financed by printing more money or borrowing, will be paid by future generations. These costs that we I just mentioned do not even include the human costs of wars and potential enemies they have created for generations to come.

6. ***Remittances***: These are monies sent by Ethiopian expatriates living overseas. Even though there is no exact estimate of this amount, the amount of Ethiopian remittances is believed to be in the range of \$1.1 billion to \$1.4 billion every year. Even though remittances provide cushions to potential economic shocks of a country and benefit receiving households, among other things, they exacerbate the "too many dollars chasing too few goods" scenario. The increased demand by those who receive and spend the remittances exacerbate the inflationary pressures created mainly by the existing shortages.
7. ***Inefficiencies within party controlled parastatals***: Everyone, including multilateral agencies such as the IMF acknowledge that the TPLF and its cadres and politbureau members control most of the major corporations. They all indicate that this is one of their concerns. Unfortunately, the same agencies never said a word when the TPLF cadres possessed the former government owned corporations and institutions at throwaway prices through the so-called privatization process. To have complete control of these institutions, the EPDRF has installed its cadres within them, , the politbureau members being heads of nearly all major corporations. These cadres, as political appointees, are just there to monitor and guarantee loyalty. They are not paid based on their efforts

towards the production of goods and services. These cadres are also highly paid! As a result, they raise the cost of production and inefficiency. The effect of this, of course, is a decrease in the aggregate supply, which results in an increase of the general price level. The inefficiency created by inserting party cadres within corporations and government agencies is, of course, an integral part of the corruption conundrum that has engulfed the country.

8. ***Shortages –both food and finished products***: The real and major culprits behind the rampant inflation rates are, in fact, the existing shortages as evidenced by the fast rising food and finished product prices! The same shortages are exacerbated by the smuggling of some grain products out the country, the TPLF-controlled or affiliated businesses and its cadres being complicit to such an activity. This being the case, Mr. Zenawi decided to inform us that the culprits behind the rising prices are a growing economy and the peasants asking more for their products! Obviously, such statements are disingenuous at best. On the one hand, the Ethiopian government has acknowledged that about 9 million Ethiopians, about one out of nine Ethiopians, are facing starvation. ***There are also pockets of places in many parts of the country, where one can easily find people affected by droughts and shortages.*** In addition, major aid organizations such as UNICEF and the United Nations indicate that the number of Ethiopians who live under food deficits *every year* is about 26 million! On the other hand, Mr. Zenawi dared to tell us, sitting in Minelik Palace, that the Ethiopian peasantry is getting richer than before! What is Mr. Zenawi to tell us about the increasing number of peasant beggars that we all see everyday in the streets of Addis Ababa and all the other cities?
9. ***Declining foreign exchange reserves***: Just like any central bank, the central bank of Ethiopia holds these assets in gold, dollars, euros and securities of possibly other countries. Each country must have enough foreign exchange reserves to allow it to service its foreign debt and import goods and services. The foreign exchange reserves are used to back the country's liabilities and its own currency. They are also used to manipulate and stabilize exchange rates. Shortages of foreign exchange reserves imply that the country will be unable to service its foreign debt and/or unable to import goods and services and important inputs used by domestic firms. If these reserves become dangerously low, capital flight and a dry-up of foreign loans may ensue. Both of these scenarios usually lead to a financial crisis. A financial crisis is a collapse of the currency, which is what is happening right now.
10. ***The Impact of the Fake Gold***: As mentioned above, central banks use gold as their reserves, as part of their capital and as collateral to their liabilities. The extent of the *gilded steel*-humorously called by Ethiopians as-*balestra*- will be unknown as the total worth of the same balestra is estimated to be between $18 million and $37 million. Indeed, this amount is relatively small even for a poor country like Ethiopia, especially compared to the amount of the looting that has been taking place in the last 17 years! It, however, speaks volumes about the extent of corruption in the country! Given that such an incredible extortion has reached even the Central Bank of Ethiopia, one can legitimately suspect that such things cannot happen without the involvement of higher authorities. As shown in You Tube, the extortion has made the country a laughing stock of world financial networks! What else would be next to steal from that poor country? What else would be left to steal!?

    The most dramatic impact of the fake gold on the country could well be its contribution to a potential *financial crisis*. The fake gold strongly indicates that the banks and financial institutions of the country are poorly supervised and their capital/asset ratios could well be inadequate. Many reports indicate that the Ethiopian lenders and borrowers are linked via special (party affiliation) ties and practices. Such an activity is called *crony capitalism*- a situation that arises when favoritism spills over to the business sector. As we all know, this is one of the factors for the East Asian financial crises, which took place in the late 1990s. It has also been reported that the Ethiopian government-owned banks are suffering from many non-performing loans. If enough of their borrowers declare for bankruptcies and/or depositors lose confidence in the banking system, such difficulties may have *contagion effects* and lead to a financial crisis. Let us hope that neither the publicly owned nor the privately owned banks have not borrowed short internationally (in hard currency) and lent long nationally (in birr). If this is not the case, there is a possibility that the country maybe heading to a financial crisis! In any case, the discovery of the fake gold within the central bank should have some negative impact on the declining birr (increased inflation rate).

11. ***Foreign debt***: The World Bank classifies Ethiopia as one of the highly indebted countries in the world. Ethiopia's debt, being over $2.8 billion in 2006, after receiving a huge debt relief in recent years, is simply unsustainable. This is just what the joint team of the IMF and the World Bank found before a debt relief was implemented. The same team undertook a detailed assessment of the country's solvency and concluded that the country was indeed insolvent. If either the country is unable to service the debt and/or the foreign creditors refuse to extend additional credit and rollover the existing debt, a financial crisis will ensue. Such a situation will be exacerbated by capital flights, as both enriched TPLF officials and foreigners move their financial assets out of the country. Some British media outlets had already indicated capital flights to have indeed taken place after the enriched officials got a scare by the 2005 Ethiopian elections results.

Past and current history of foreign debt clearly indicates that large-scale foreign debt is highly correlated with corruption and embezzlement of money by the elite in developing countries (who were often placed in power by the powerful countries themselves). As mentioned above, such a scenario was detected after the 2005 Ethiopian election. It is also important to remember many loans also come with very strict conditions, a couple of them being *preferential exports* and *structural adjustment policies*. As part of the structural adjustment policies, among other things, debtor nations are required to liberalize their economies, allow free markets so that their resources could be easily extracted, privatize domestic industries, cut back their expenditures, eliminate/reduce their subsidies and tariffs. They are also told to reduce investment regulations in order to attract foreign investment. For anyone who has followed the ***special*** relationship between Ethiopia and the IMF and the World Bank, these conditions ring a bell on his/her ears! When things go out of hand, the IMF, the World Bank and lender nations also ask debtor nations to devalue their currencies and increase their interest rates. In fact, the IMF notes that the birr is overvalued and the interest rates are too low. If the rampant inflation rates continue to rise unabated, it will not be long for these two agencies to put the familiar ***conditionalities*** on the country- raise interest rates and devalue the currency! Both of them will bring hardship for the country and the people!

12. ***Rising world food Prices***: The rising world food prices do not appear to have any significant impact on the Ethiopian rampant inflation rates. This is in part because the world food crisis is a relatively recent phenomenon while the Ethiopian high inflation rates are endemic in nature. The rising world food prices, however, could have a devastating impact on the Ethiopian rampant inflation rates. This is so in part because the main causes of the country's high inflation rates are ***food shortages*** and any food shortages in the rest of the world will just make things worse.

I would also like to point out the fact that, as of this writing, nations such as the United States are planning to cut their food aid to recipient nations such as Ethiopia. The World Food Program has also announced that it will cut its food aid supplies to the same recipient nations, including Ethiopia. All of these add up to the already existing shortages inside Ethiopia. Shortages are the worst causes of rising prices. It is also legitimate to expect for the regime in Addis Ababa, sooner or later, to blame the world's food shortages to cover up the shortages its policies have created within the country.

13. ***Budget and Current Account Deficits***: A nation faces a budget deficit when the government spends more than it takes in as taxes. The budget deficit for 2007 was expected to be $740 million, with a debt/GDP ratio of close to 54.5%. One potential concern regarding the annual budget deficit and/or debt is that, if they grow sufficiently large relative to GDP, lenders could begin to question the government's creditworthiness and then demand very high interest rates. This would have serious consequences for investment and growth. To rectify the budget crisis, the government would have to cut spending and/or raise taxes. Both the cut in spending and the increase in taxes would lead to an economic recession. Nearly 40% of the government's budget being financed by bilateral aid and ODA, one can safely hypothesize that a dry-up on these funds could easily lead to a collapse of the government.

14. ***The Monetization of Food Aid:*** This is the money spent by aid organizations to help starving Ethiopians (known as cash funding). It has been reported that aid agencies and NGOs are locally buying some of the food aid that they deliver to needy Ethiopians. To be honest, many economists, including this writer, believe that it is better to grant poor nations income support in the form of cash or vouchers to help purchase local commodities, rather than flooding developing world food markets with international food. Among other things, the cash grants or vouchers stimulate local markets while the food aid depresses them. At the same time, however, ***purchasing the food within the country has the potential to drive up the local price, thereby exacerbating the inflationary problem!*** Moreover, the constant presence of aid agencies and NGOs who are feeding the needy Ethiopians clearly show that there are insufficient resources available to deal with Ethiopian hunger at present. Again, such a situation clearly indicates a shortage, and not a sign of economic development and an increase in demand!

According to the *CIA World Fact Book*, the Ethiopian current account for 2007 was estimated to be $1.851 billion, but the IMF estimates indicate it to be $3.891 billion. The reader is to be reminded here that this amount is only a one-year current account deficit. The sum of all the current account deficits, accumulated over time, becomes the country's international debt. When a country borrows too much, as is the case for Ethiopia, any future income obtained via imports will go to foreigners rather than the people in the country (to pay for a portion of the principal plus interest). In other words, Ethiopia will be poorer, just like with a budget deficit. Secondly, as happened to many countries in the past, such a large relative to GDP growth annual current account deficit and/or foreign debt could invite lenders to question the country's creditworthiness and then demand very high interest rates. This would have serious consequences for investment and growth. In addition to the higher nominal interest rates, a high current account deficit, in general, is followed by a falling domestic currency. A falling currency makes foreign imports to be more expensive relative to exports. To rectify the current account deficit, the government may resort further to devalue the currency. A devaluation of the birr may instigate capital flights leading to a financial crisis. A financial crisis always leads to an economic recession and high unemployment. Both of these macroeconomic imbalances (that is, the internal budget deficit and the external deficit) contribute to the existing inflation rates and are in general culprits behind financial crises.

One should not forget the impact of the U.S. economic problem. The current U.S. economic crisis is expected to have a negative impact on the world economy. Some economists are even predicting a worldwide recession. Whether the recession becomes worldwide or not, a huge meltdown in the U.S. economy is expected to take place. A drop in commodity prices is also expected to take place. As a major exporter of commodities such as coffee, gold, and oil seeds, Ethiopia may face dramatic drops in its exports resulting in a further deterioration of the already blotted current account deficits.

Clearly, all the above factors indicate that the culprits behind the rampant Ethiopian inflation rates are neither the growing economy nor the Ethiopian peasantry getting richer than before. It should be pointed that, as happened during the Derg regime and elsewhere in the world, it is customary for a dying regime to blame merchants as hoarders of commodities in order to deflect attention from the shortages that its disastrous policies created.

Now, is the rampant inflation reversible? Alternatively, one may add a related question: Can the Ethiopian government stop a potential financial crisis taking place in the country in the near future? The answers to these questions clearly depend on whether the government would be able to reverse the causes of the rampant inflation rate and symptoms of the financial crisis listed above. If the answer is, "No, the government is incapable to reverse them," then buckle up, poor Ethiopian people: more hunger, hardships, desperations, may be in the offing! If what is happening now is not enough, more of the country's citizens will try to flock out of the country, thereby risking their lives while trying to flee, and be abused by their foreign masters. God forbid!

The author can be reached at: seid.hassan@murraystate.edu

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[i] For those of you who are acquainted with economics, the concepts of demand-pull and cost push inflation have become less appealing to the economics profession. As a result, most current principles textbooks do not even bother to cover these topics.