

DOCUMENT OF INTERNATIONAL MONETARY FUND AND NOT FOR PUBLIC USE

EBS/87/58

CONFIDENTIAL

March 11, 1987

To: Members of the Executive Board

From: The Secretary

Subject: Ethiopia - Real Effective Exchange Rate - Information Notice

Attached for the information of the Executive Directors is an information notice on the real effective exchange rate of the Ethiopian birr.

Mr. Bélanger (ext. 8671) is available to answer technical or factual questions relating this paper.

Att: (1)

CONFIDENTIAL

INTERNATIONAL MONETARY FUND

ETHIOPIA

Real Effective Exchange Rate--Information Notice

Prepared by the African Department and the
Exchange and Trade Relations Department

(In consultation with the Legal Department and the
Research Department)

Approved by A.D. Ouattara and S. Kanesa-Thanan

March 10, 1987

The recent evolution of Ethiopia's real effective exchange rate, as measured by the standard index developed in connection with the information notice system, is set out in the attached table and chart. Based on this index, as of December 1986, the Ethiopian birr had depreciated in real effective terms by 11.2 percent since the last occasion on which the Executive Board had an opportunity to discuss Ethiopia's exchange rate policy--the Article IV consultation in July, 1986. 1/ 2/

Since February 1973, the birr has been pegged to the U.S. dollar at an exchange rate of Br 1 = US\$0.48309. The real effective exchange rate of the birr has thus been affected importantly by fluctuations in the exchange rate of the U.S. dollar relative to other major currencies. Sharp fluctuations in domestic prices in Ethiopia have also exerted an increasingly important influence in recent years. Reflecting the appreciation of the U.S. dollar, and despite relatively low rates of inflation in Ethiopia, the birr appreciated by nearly 25 percent in real effective terms from 1980 through early 1984. By early 1985, however, the appreciation in real effective terms had reached nearly 70 percent as the sharp acceleration of domestic inflation reflecting principally the serious shortfall in agricultural production and consequent severe

1/ Chairman's summing-up circulated as SUR/86/78 (8/4/86).

2/ As described in the most recent quarterly report on "Indicators of Real Effective Exchange Rates" (EBS/86/278, 12/18/86), a new weighting scheme has been introduced for the calculation of nominal and real effective exchange rates involving, in particular, a more comprehensive representation of direct and third market competition for trade in manufactures and primary commodities. The new weights have not typically changed substantially the estimates of real effective exchange rates. In the case of the Ethiopian birr, based on the weights used previously, the depreciation in real effective terms from July to December 1986 would have been 11.4 percent.

food scarcity further accentuated the effects on the real effective exchange rate of the continued appreciation of the U.S. dollar. Since then, the depreciation of the birr along with the U.S. dollar and declining domestic prices, as relief efforts and a recovery of production alleviated food shortages, have reversed most of the earlier appreciation in real effective terms. By December 1986, the real effective appreciation of the birr relative to 1980 amounted to only 5 percent.

With the return of normal rains in 1985/86 (July/June), the Ethiopian economy began to register a recovery, with GDP increasing by about 11 percent. Production of both food and export crops increased substantially and the agricultural sector as a whole expanded by more than 20 percent. A continued restraint on government expenditure resulted in a reduction of the overall budget deficit to 6.5 percent of GDP (from 8.1 percent in 1984/85). Domestic credit expanded by 7.8 percent, but broad money rose by 15.5 percent, reflecting also an increase in net foreign assets. The country's terms of trade improved because of an increase in coffee prices and a decline in oil prices. Total export volume increased while total import volume was little changed (an increase in regular imports was offset by a decrease in relief imports), and the trade deficit was reduced to about SDR 430 million from SDR 620 million the previous year. The external current account deficit declined to the equivalent of 6.8 percent of GDP (from 8.8 percent the previous year) and the overall balance of payments recorded a surplus of SDR 151 million against a deficit of SDR 48 million the preceding year. At the end of June 1986, gross official reserves were equivalent to four months of imports.

In concluding the recent Article IV consultation in July 1986, Executive Directors urged the Ethiopian authorities to adopt and implement flexible exchange rate and interest rate policies and appropriate domestic pricing policies in order to improve efficiency in the economy, encourage private sector activity and promote exports. Such measures were seen as necessary to strengthen the balance of payments position and permit the authorities to ease trade and exchange restrictions. In this regard, Directors encouraged the authorities to adopt macro-economic and structural adjustment measures in the context of a medium-term program under the structural adjustment facility.

The most recent assessment by the staff indicates a weakening of the balance of payments position in 1986/87, mainly as a result of a drop in coffee prices and the reluctance of the authorities to adopt the necessary adjustment measures. Reflecting the worsening of the trade performance, both the current account and overall balance of payments are expected to worsen, the surplus in the latter being reduced substantially in the course of 1986/87 and reverting to a large deficit in the following year.

Staff Appraisal

In contrast with 1985/86 when high coffee prices contributed to the strengthening of the balance of payments, the recent decline of coffee prices has again brought out the underlying weakness of the balance of payments. Accordingly, the real effective depreciation of the birr since early 1985, induced in part by the depreciation of the U.S. dollar to which the birr is pegged, is welcome. The appropriateness of the current level of the exchange rate and of supporting policies will be discussed with the authorities, in light of the need to promote the production of exports and import substitutes and to generally restructure the economy, during the forthcoming discussions for the 1987 Article IV consultation which are scheduled for April-May, 1987.

Table 1. Ethiopia: Real Effective Exchange Rate and Related Series

(Indices: 1980 = 100)

	Real Effective Exchange Rate <u>1/</u> <u>2/</u>	Nominal Effective Exchange Rate <u>1/</u>	Relative Consumer Prices (Local Currencies)	Exchange Rate in Terms of U.S. Dollars <u>1/</u>	Consumer Price Index (Seasonally Adjusted)	Consumer Price Index (Not Seasonally Adjusted)
Quarterly						
1982						
I	116.9	129.4	90.3	100.0	112.5	110.3
II	115.1	134.2	85.7	100.0	109.9	111.4
III	119.3	140.8	84.7	100.0	112.0	113.4
IV	123.9	145.5	85.1	100.0	115.2	114.5
1983						
I	121.1	146.7	82.5	100.0	114.4	112.0
II	121.0	153.8	78.6	100.0	112.2	113.7
III	120.5	162.6	74.1	100.0	109.3	110.8
IV	121.8	167.7	72.6	100.0	110.8	110.0
1984						
I	123.6	172.1	71.7	100.0	112.4	109.9
II	131.0	176.3	74.3	100.0	119.6	121.2
III	138.0	189.3	72.8	100.0	120.7	122.8
IV	153.0	199.7	76.6	100.0	131.0	130.1
1985						
I	169.5	214.2	79.1	100.0	139.7	136.3
II	168.0	212.4	79.1	100.0	144.3	146.2
III	166.8	207.2	80.5	100.0	150.7	153.6
IV	146.4	199.4	73.4	100.0	141.3	140.4
1986						
I	134.3	192.9	69.6	100.0	137.9	134.3
II	122.4	188.6	64.9	100.0	130.2	131.9
III	117.1	182.6	64.1	100.0	130.2	132.9
IV	108.3	182.2	59.4	100.0	122.5	121.4
Monthly						
1986						
July <u>3/</u>	118.7	185.2	64.1	100.0	129.4	132.2
Aug.	119.6	181.6	65.8	100.0	133.7	134.3
Sept.	113.1	181.2	62.4	100.0	127.4	132.2
Oct.	110.8	180.9	61.2	100.0	125.5	127.9
Nov.	108.4	183.3	59.1	100.0	122.0	120.7
Dec.	105.4	182.4	57.7	100.0	119.9	115.7
Percentage change						
July-Dec. 1986	-11.2	-1.5	-9.9		-7.4	

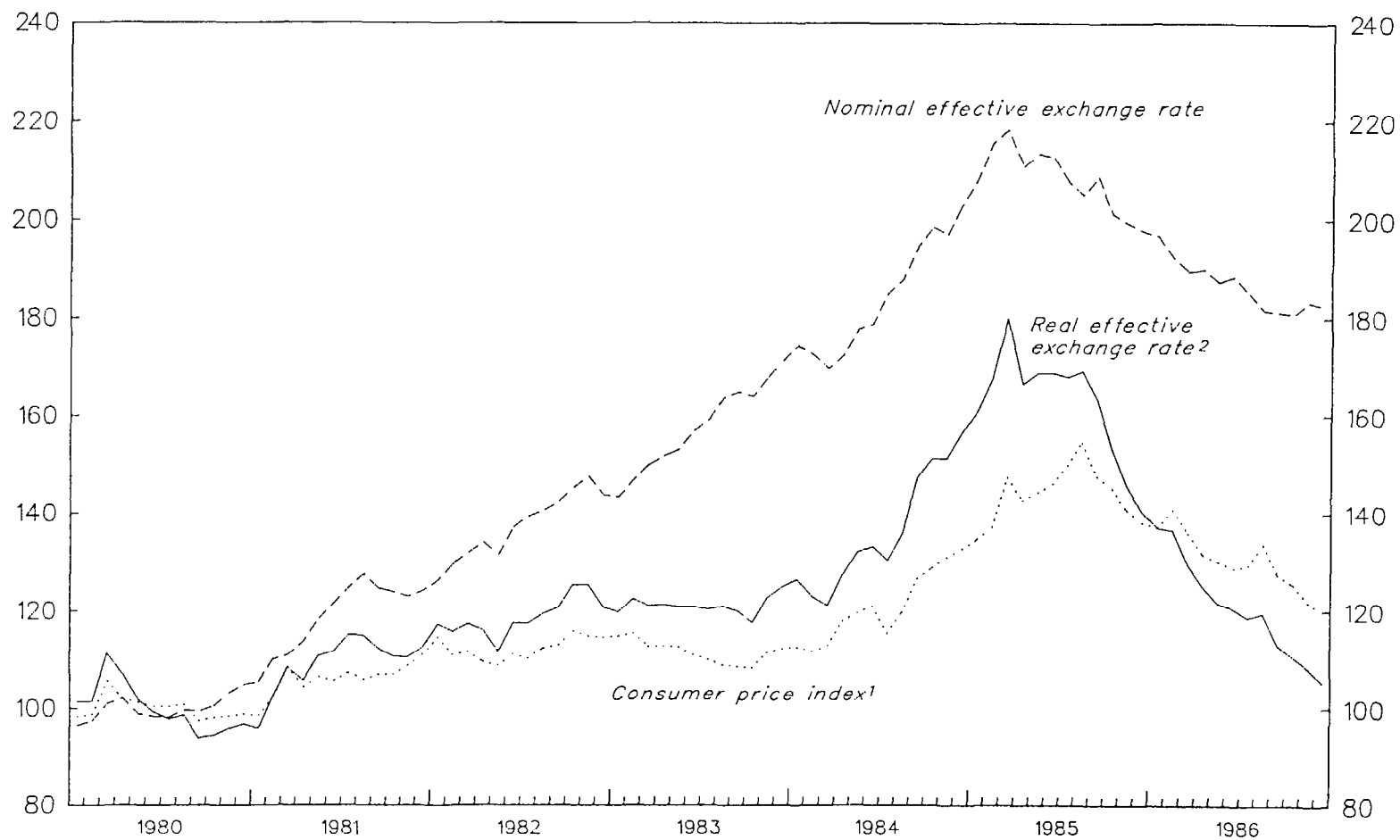
Source: Information Notice System.

1/ Increases mean appreciation.

2/ Using seasonally adjusted price indices.

3/ Date of latest consideration by Executive Board.

CHART
ETHIOPIA
INFORMATION NOTICE SYSTEM INDEX OF REAL EFFECTIVE EXCHANGE RATE
(1980=100)



Source: Information Notice System.

1 Seasonally adjusted.

2 Trade-weighted index of nominal exchange rates deflated by seasonally adjusted relative consumer prices, increases mean appreciation.

