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Working Paper

Ethiopia's high growth and its challenges: Causes and prospects

Working Paper, No. 70/2016

Provided in Cooperation with:

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Suggested Citation: Priewe, Jan (2016) : Ethiopia's high growth and its challenges: Causes and prospects, Working Paper, No. 70/2016, Hochschule für Wirtschaft und Recht Berlin, Institute for International Political Economy (IPE), Berlin

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Ethiopia's High Growth and Its Challenges – Causes and Prospects

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Working Paper, No. 70/2016

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Ethiopia's High Growth and Its Challenges – Causes and Prospects

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Abstract: The paper analyses the enigmatic high growth in Ethiopia from 2004 to 2015 (10.9% p.a.) and gauges the prospects for the future. In 2000, Ethiopia was the poorest country on the globe in per capita GDP – a mere 124 USD in current prices. The main finding is that the take-off was driven by heterodox monetary and fiscal policy which targeted public expenditure for infrastructure. This triggered an increase in domestic demand, reinforced by strongly rising terms of trade under buoyant growth of the global economy until 2008. The combination of favourable factors induced strong productivity leaps mainly in agriculture and lifted millions of smallholder peasants at least partially out of subsistence economy toward participation in markets. Aggressive expansionary macroeconomic policies triggered bulging fixed investment, much beyond a narrow public expenditure boom. Despite two heavy inflation episodes, inflation and the emerging high current account deficit seem under control in 2016. The main downside of the strategy followed by Ethiopian authorities is the unabated appreciation of the real effective exchange rate and the unclear consequences of the past commodity price boom. Tolerated high inflation, mainly due to commodity hikes on the world markets, was not sufficiently offset by nominal depreciation. Despite the stellar achievements in poverty reduction and other developmental goals, the strategy incorporated in the “Growth and Transformation Plan” (GTP) does not sufficiently address the failure of industrialisation, focused on manufacturing. Ethiopia has the third lowest rank in manufacturing as a share of GDP in the group of low-income countries, reaching only half of the average in this group. Without a surge in industrialisation the country is unlikely to find an escalator toward a middle-income economy by 2025 as envisioned in GTP II. This would require a turnaround to direct industrial policy (beyond establishing “industrial parks”) and real undervaluation of the currency, which would require a change in monetary policy. A possible alternative route for the medium term could be to further postpone massive industrialisation and correction of the exchange rate and focus intensively on full eradication of poverty and malnutrition. This could unleash productivity gains in agriculture with vast positive external effects. The strategy switch to industrialisation would then come after this phase. We leave the choice of options open in this paper. The prospects of continued very high growth in GTP II seem over-optimistic in face of the slowdown of commodity prices and problems of industrialisation. But good development is not necessarily growth maximisation.

Keywords: Economic development, Africa, industrial policy, foreign exchange policy

JEL Code: O11, O14, O24, O25, O47, O55

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1. A miracle?

Ethiopia has enjoyed stunning, high growth since 2003, now for 13 years. This “growth acceleration” – there was only meagre per-capita growth before 2003 in the period 1992-2003 – is unique in Sub-Saharan Africa (SSA) and also in international comparison. This growth period is even more surprising since it occurred in one of the poorest countries in the world, since it brought strong improvements in key developmental indicators like poverty reduction, life expectancy etc., and since the policies applied differ substantially from standard orthodox or mainstream thinking in the tradition of the “Washington Consensus”. The Ethiopian government intends to implement the next phase of the “Growth and Transformation Plan” (GTP 2010, GTP 2015), for the period 2015-2020, with continued mega high growth rates and structural changes toward industrialisation. In the broader international academic community of economists Ethiopia’s outstanding performance has not yet found the attention it deserves.

This paper wants to decipher the roots of the past growth “miracle” and discuss different explanations. In the next chapter (2.) we will review the past performance of the Ethiopian economy since the early 2000s in a descriptive overview. In the third chapter we give our explanatory narrative for the changes witnessed. In the fourth chapter we discuss different views on Ethiopia’s growth story, mainly from World Bank and IMF authors. In the fifth chapter we conclude and discuss conditions for further high growth.

Our view of the Ethiopian economy is inspired by Keynesian and structuralist thinking in the tradition of the pioneers of development economics who opted, more or less vocally, for “a big push”, a comprehensive state-led concept with a “developmental state” and structural policies with industrialisation as a centre piece (see Calcagno et al. 2015 and Priewe 2015 for modern development strategies in this tradition). Through this lens, the high growth is mainly explained by aggregate demand acceleration plus structural policy (not to be conflated with “structural reforms”) and their favourable consequences for the supply side of the economy. The key challenges for this strategy, inflationary risks and external imbalances, had been coped with under conditions of rising terms of trade and increased foreign aid. The ambitious prospects depend very much on the success of industrialisation, and to a lesser degree on mere continuation of past policies. Industrialisation requires more than what is addressed in GTP II, namely a full-fledged industrial policy supported by new monetary and

exchange rate policy. An alternative option which postpones this strategy switch for a couple of years is sketched in the conclusions.

2. Reviewing Ethiopia's economic performance 2000-2015

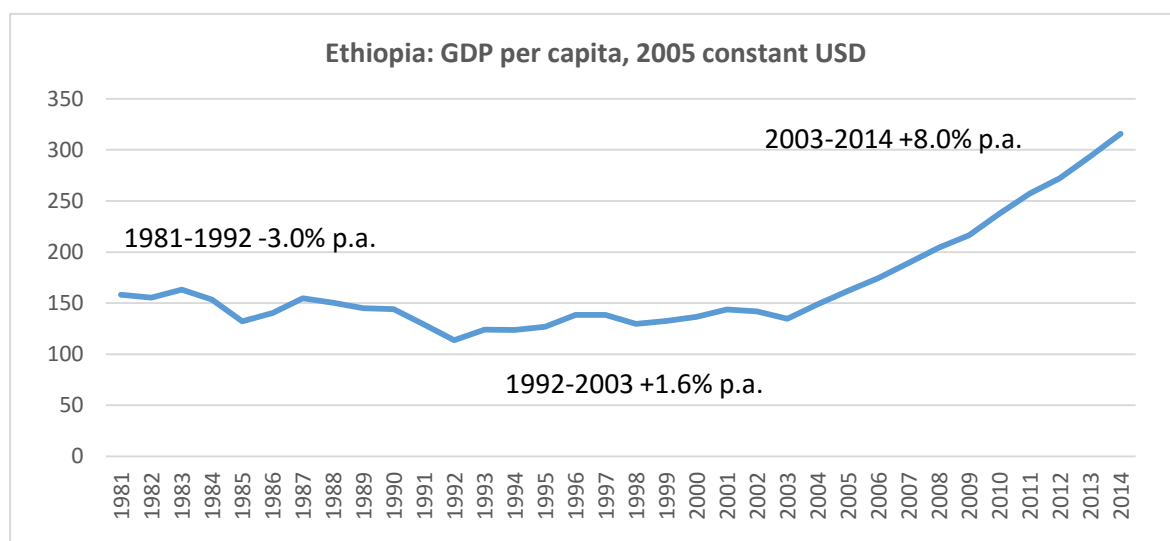
GDP per capita grew from 2003 to 2014 by 8.0% p.a., increasing 2.3 fold; overall GDP increased by 10.9% p.a.¹ Absolute poverty halved between 1995 and 2010, with still one third of the 97 million population being about 8% below the poverty line of 1.90 USD per day per capita (in PPP terms). Income inequality remained low. Even considering any slight inaccuracies in the data, the success is outstanding, and not only in growth terms (cp. UNDP 2015). The IMF had estimated that the real GDP figures might be overstated since they imply an extreme increase in total factor productivity (using standard "growth accounting"), which IMF authors consider implausible when compared to other low-income countries (IMF 2012). Since there are not many countries with such a low income per capita, reflecting the high share of smallholder peasant households living in partial subsistence, comparisons have only limited value. We have to leave this issue open. Even if the IMF suspicion is correct, growth seems to be high – a systematic statistical error would likely distort the statistical *level* of income rather than its growth. Countries growing out of subsistence into market economies seem to show peculiar statistical features.

Over the long haul, Ethiopia experienced negative growth under the Derg regime, then in 1992 returned to low per capita growth until 2003 when – after the war with Eritrea from 1998-2000 and a drought from 2002-2003 – the turnaround to high growth started (see graph 1). It seems as if a certain potential for unfolding growth had been accumulated under the bleak former periods. This presumption implies unused growth potential at the onset of the growth acceleration.

In 2005 the per capita income level of 1983 was recovered. It is very likely that in these 22 years developmental advances had been accomplished which had not (yet) been reflected in higher GDP. In the period from 2003-2014 the population skyrocketed by 35%, between 2000 and 2014 by 47%. The population structure was younger than in earlier periods.

¹In this paper we use data from the World Bank and IMF, mostly depending on official data from the Ethiopian Central Statistical Agency although we are aware that – as in all low-income countries – there is a sizeable informal economy, including trade and cross-border financial transactions.

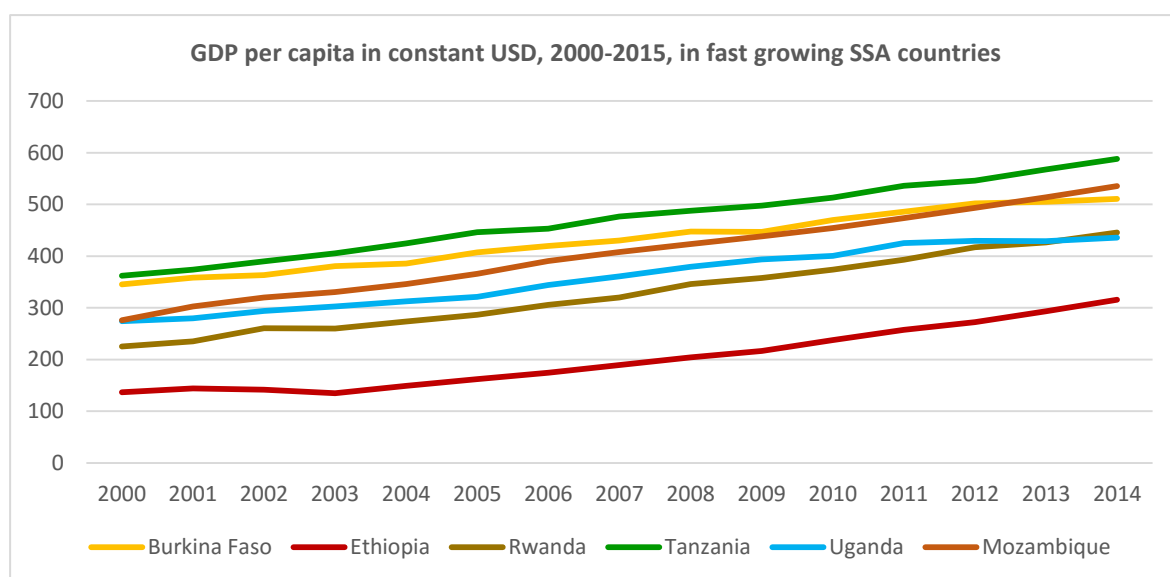
Graph 1



Source: World Development Indicators. IMF World Economic Outlook (IMF 2016) reports for 2015 a growth rate of 10.2%, but a drop to 4.5% 2016 (estimation).

Compared with other fast growing SSA-countries, Ethiopia grew in terms of per capita GDP on a distinctly lower level of income compared to its main peers (see graph 2). Among the 25 worldwide poorest countries in 2014 Ethiopia ranked the 10th lowest, excluding countries with no data available, like Eritrea or Somalia (see graph 3). In 2000, Ethiopia ranked globally as the poorest country with just 124 USD (in current prices) per capita, compared to 574 USD (in current prices) per capita in 2014.²

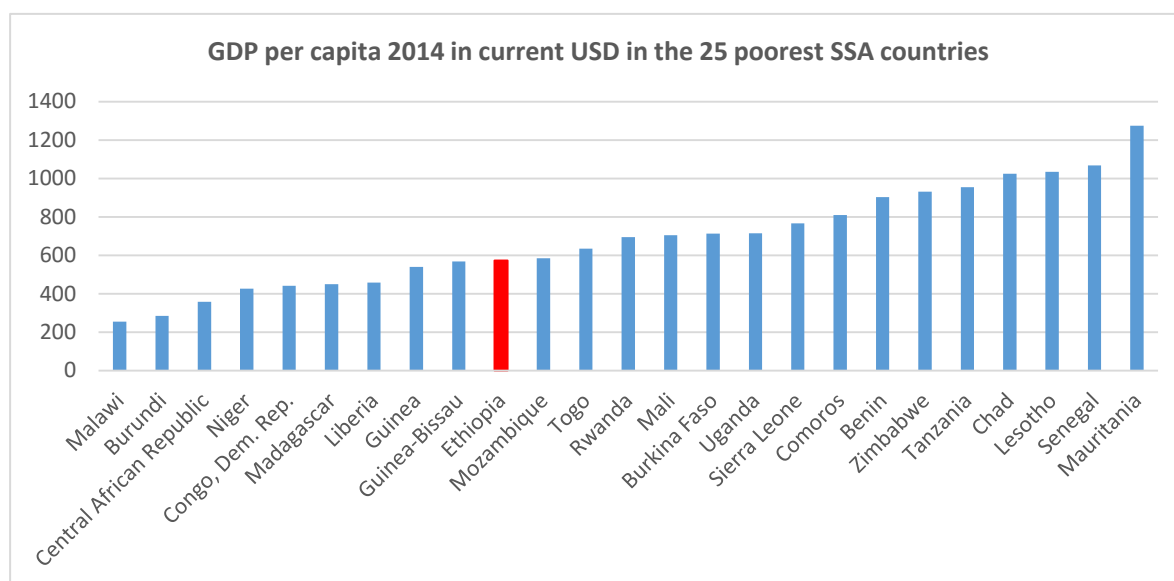
Graph 2



Source: World Development Indicators.

² In 2000 and also in 2003 Ethiopia was globally the poorest country (in *constant* 2005 USD), and the 9th poorest in 2014 (based World Development Indicators).

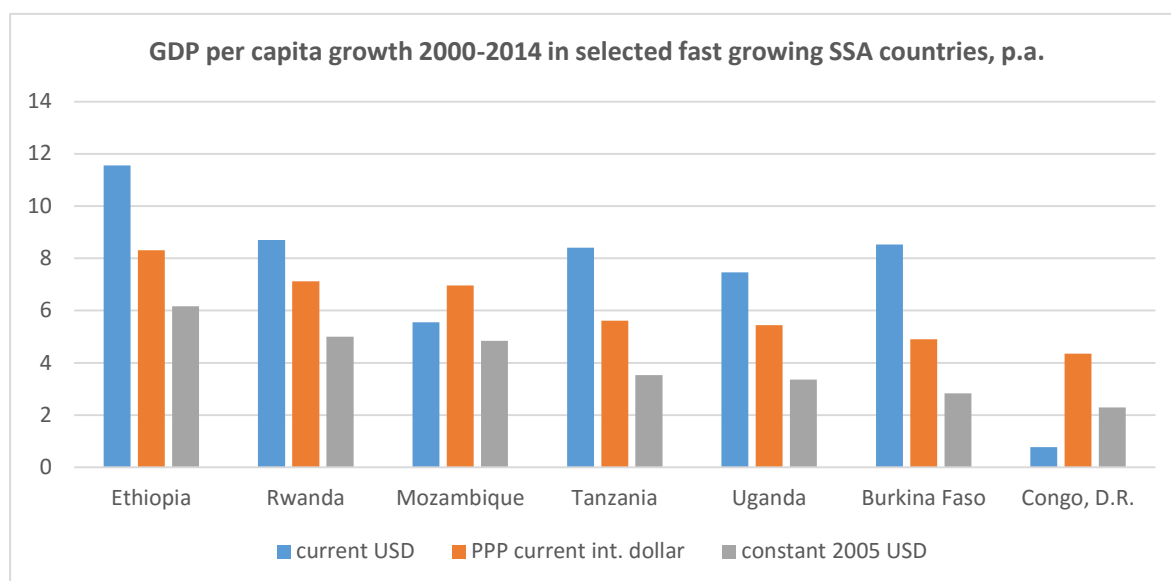
Graph 3



Source: World Development Indicators.

The comparison of different growth indicators shows Ethiopia as the top runner before the other peers, with Rwanda and Mozambique on ranks two and three (see graph 4). GDP per capita in constant 2005 USD, equivalent to constant local currency units, gives the best measure for real growth; GDP per capita in terms of PPP international dollar gives somewhat higher growth rates for all countries. This measure, often used for international comparisons of incomes for specific years, is in our view not useful if the change in real income within a country is to be captured. PPP values display the worth of local currency if spent in the US or vice versa. Besides this not very relevant measure, the consumer baskets between extremely different countries are likely to differ so much that comparisons are senseless. Ethiopia's growth per capita of 6.1% for the period 2000-2014, compared to 5.0% and 4.8% for Rwanda and Mozambique respectively, is no longer so extremely outstanding. For 2003-2014 growth was markedly better, at 8.0%.

Graph 4

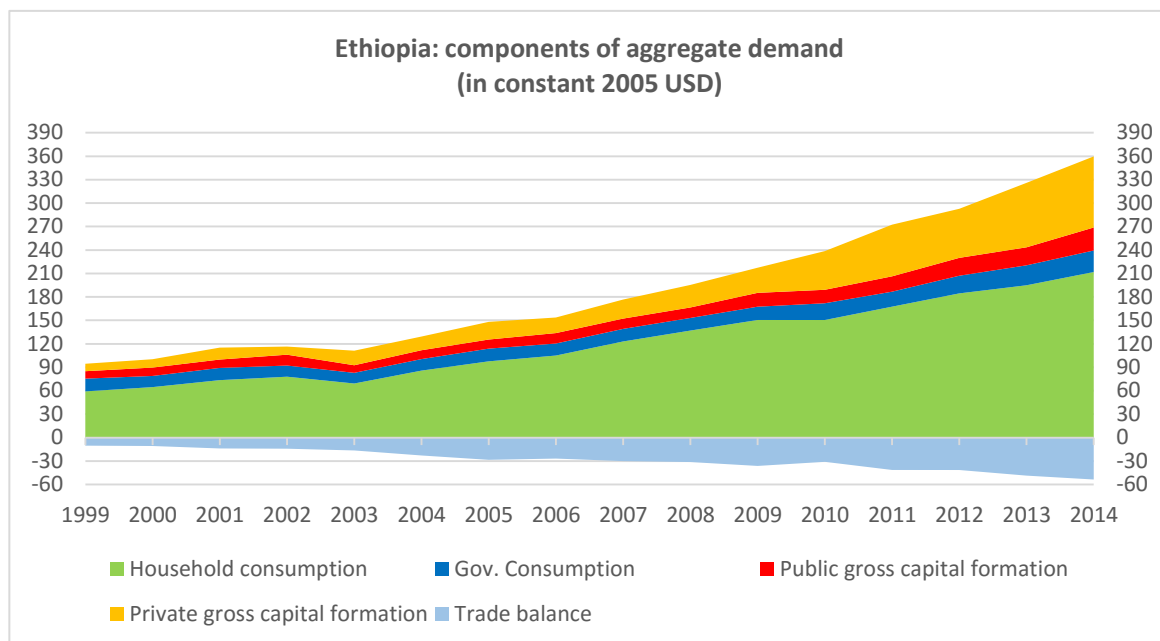


Source: World Development Indicators.

Now we look at the dynamics of aggregate demand in Ethiopia (graph 5 and 6). Growth was clearly consumption driven, more precisely by household consumption. Yet, gross investment was the most dynamic component of aggregate demand. Public investment, mainly for infrastructure of various kinds, had a share of around 10% of GDP, ranging between 8% and 14%. Roughly half of the government budget is spent on public investment, an outstanding figure compared to earlier periods and to other countries in the region. However, “private capital formation” (wording of National Bank of Ethiopia, NBE, the central bank)³ outpaced the government’s share when total capital formation swelled in its share of GDP from 22% in 1999 to 37% in 2014. The bulk of the investment dynamics as a share of GDP came from the enterprise sector in the course of the period analysed. In 2014 private investment was three times that of public investment.

³ We assume that the “private sector” includes public enterprises and embraces the entire enterprise sector.

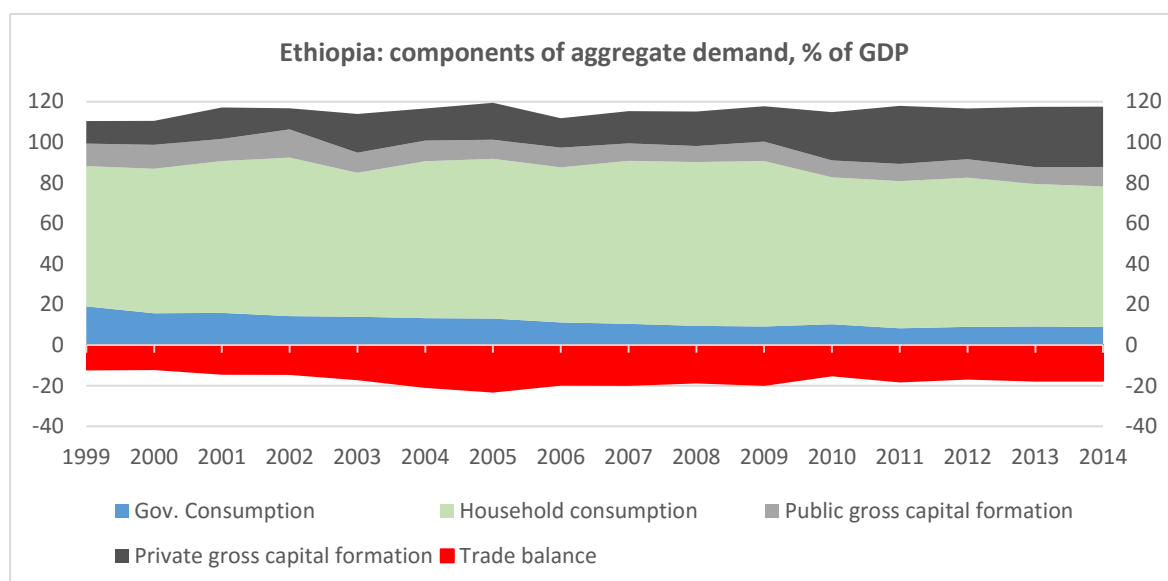
Graph 5



Note: years are fiscal years, spanning across two calendar years (e.g. 1999/2000). Split of gross capital formation in private and public components for 1999 and 2000 are estimates.

Source: NBE, Annual Report 2014/15; own calculations.

Graph 6

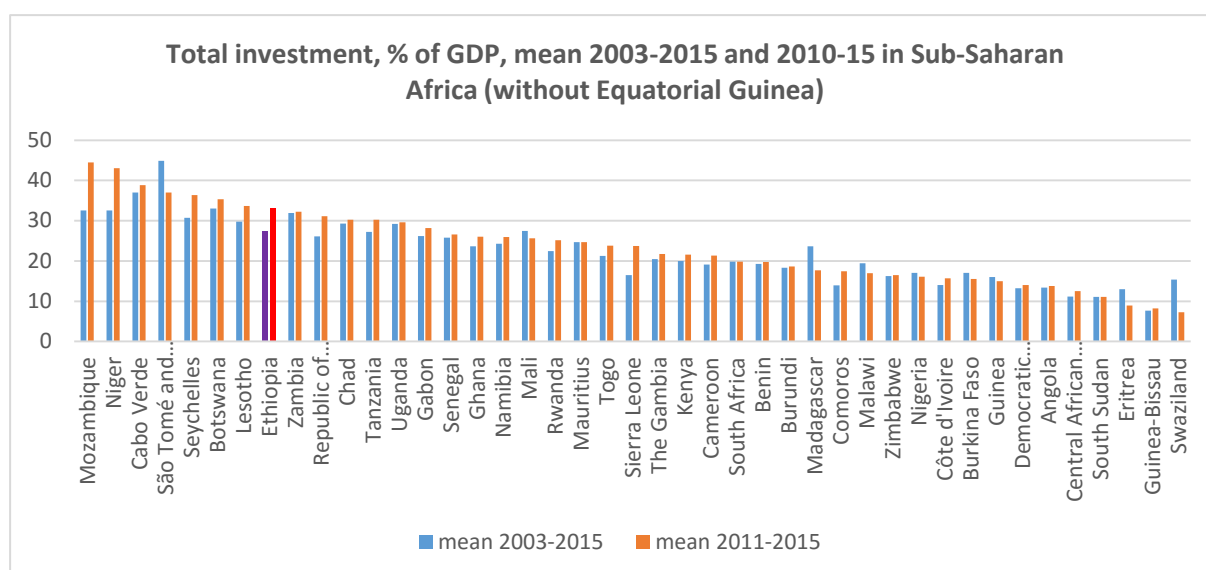


Source: see graph 5.

Compared to other SSA countries, Ethiopia ranks high in the investment/GDP share, but is not outstanding (graph 7). The average of all SSA countries (excluding Equatorial Guinea) in the periods 2003-2015 and 2010-2015 was 24% and 22% respectively. Ethiopia has a higher share than Uganda, Tanzania, and Rwanda but a slightly lower share than Mozambique. To a

larger extent than in earlier periods, financial inflows from abroad were used directly or indirectly for investment.

Graph 7

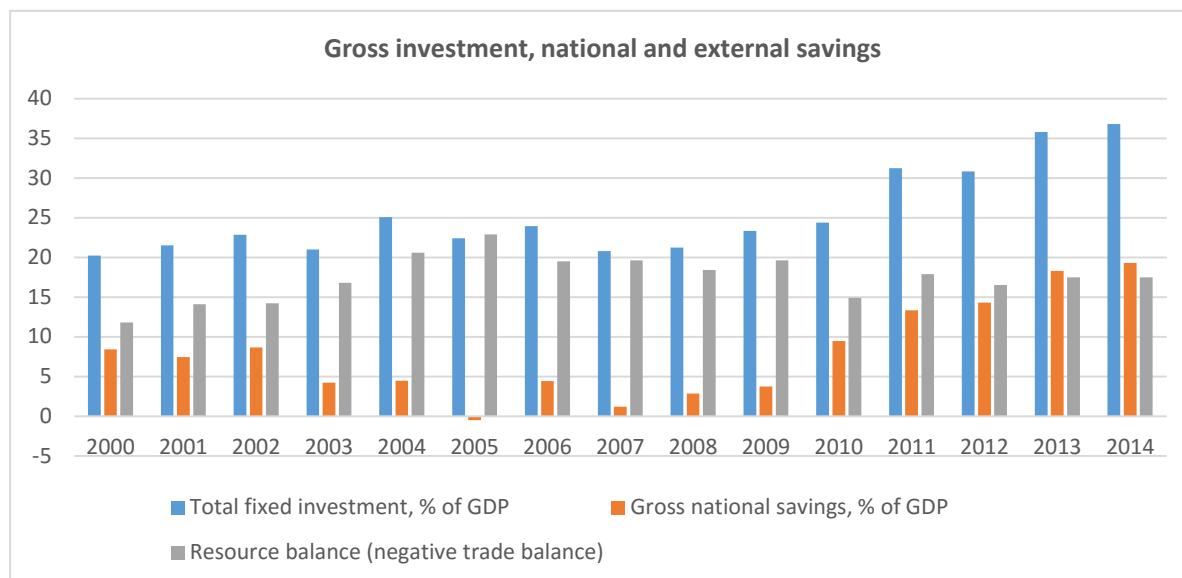


Source: IMF, World Economic Outlook, October 2015. Figures for 2014 and 2015 are partially IMF estimates.

In 2014, the country spent roughly 17% more than it earned. Absorption stood at 117% of GDP, meaning the trade balance (goods and services) had a deficit of 17%, which rose over the years in absolute terms, though not relative to GDP. Export performance remained relatively poor, while imports boomed in both absolute terms and relative to GDP. This looks like a classical growth-cum-debt strategy, which in previous examples so often failed, especially in Latin America, or led to chronic aid dependency with stymied growth.

Graph 8 illustrates the problem more succinctly. The national accounting identity stipulates that gross investment equals the sum of “national savings” (income not spent for consumption) and net exports, considered as the negative value of the trade balance or the net resources (goods and services) imported or exported. The term “national savings” is misleading, as it does not indicate finance; it is just the share of output not consumed by households or government. Graphs 5 and 6 show that gross investment almost doubled as a share of GDP from 2000 to 2014, reaching nearly 37% of GDP. The share of “national savings” shrank until 2007 and rose afterwards up to 19% of GDP in 2014.

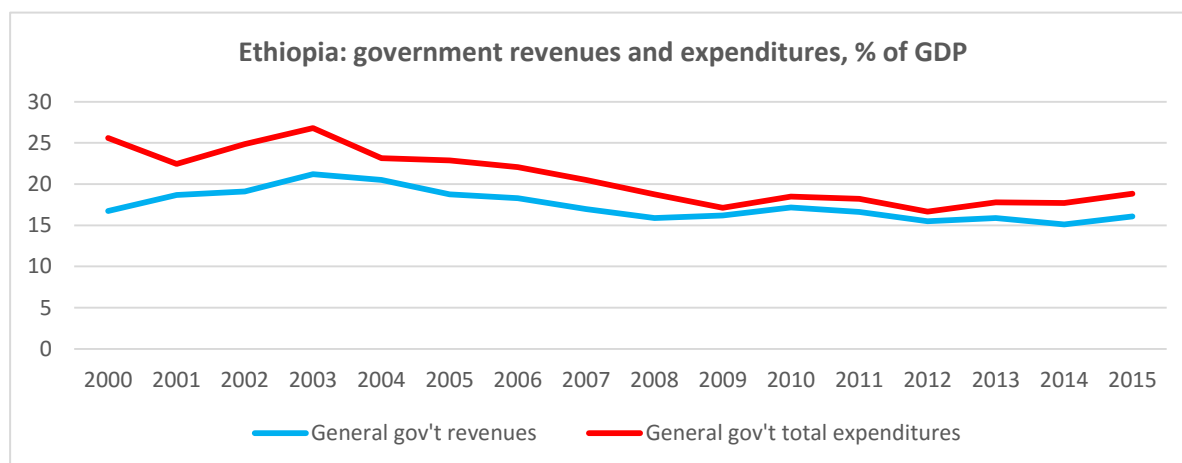
Graph 8



Source: NBE, Annual Reports, several years, own calculations.

Government spending as a share of GDP has risen in the period analysed, so that it can be said that Ethiopia's growth was state- or public-spending led growth (graph 9). Government revenues rose in parallel with expenditures, however this figure also includes grants from external donors.

Graph 9

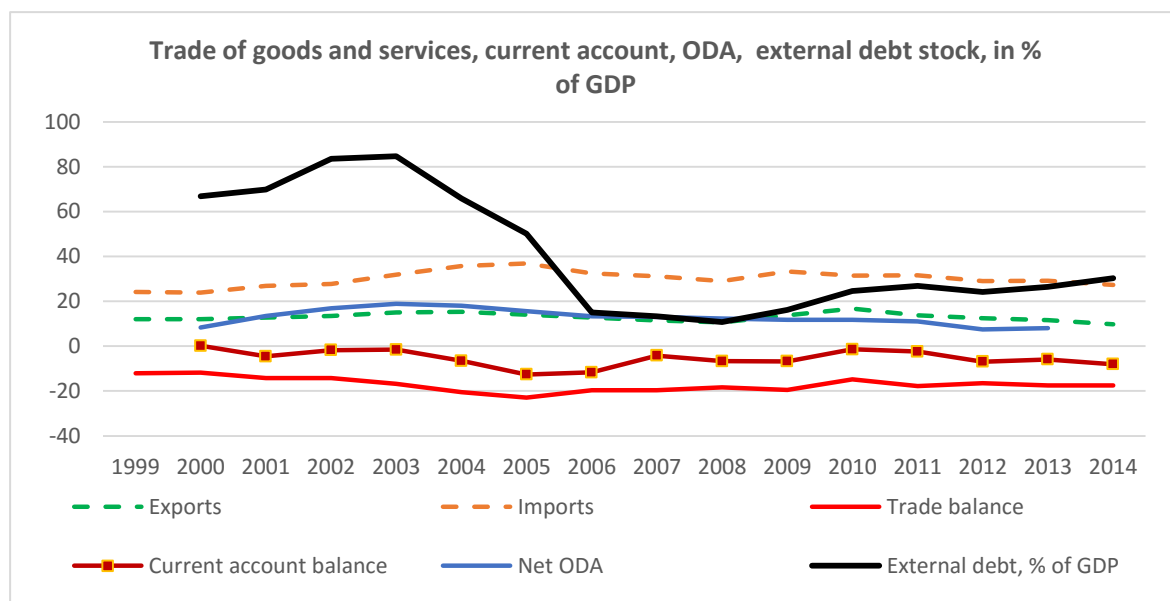


Source: IMF, World Economic Outlook.

The huge gap between exports and imports – 9.8% and 27.3% of GDP respectively – is as stunning as the high growth dynamics. It is surprising, however, that the external debt stock relative to GDP rose moderately after the debt relief of creditors in 2006 (see graph 10) and stands at around 30% of GDP in 2015. The current account balance performed much better

than the trade balance, with a deficit hovering between 0% and 12% of GDP.⁴ Of course, the differential has to do with aid, especially grants, and remittances.

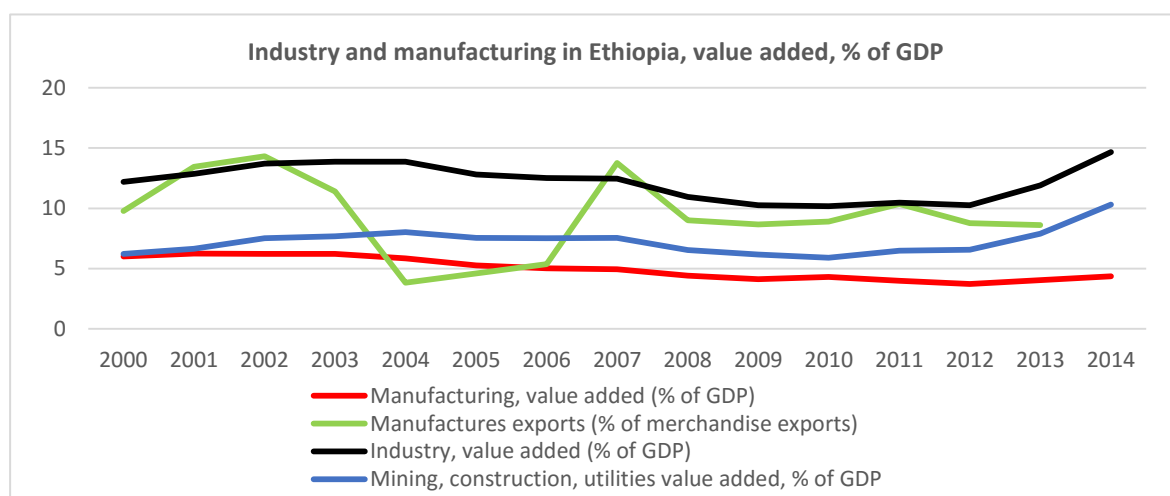
Graph 10



Source: CAB from IMF WEO, trade data NBE, Annual Report 2014/15.

Export growth was outpaced by imports. This reflects Ethiopia's production structure as a non-industrialised country. Although the industrial sector rose as a share of GDP, it was caused mainly by a construction boom and rising utilities, whereas manufacturing, representing the core tradeables within industry, shrank slightly, accounting for 4.3% of value added, contributing less than 9% to merchandise exports (see graph 11).

Graph 11

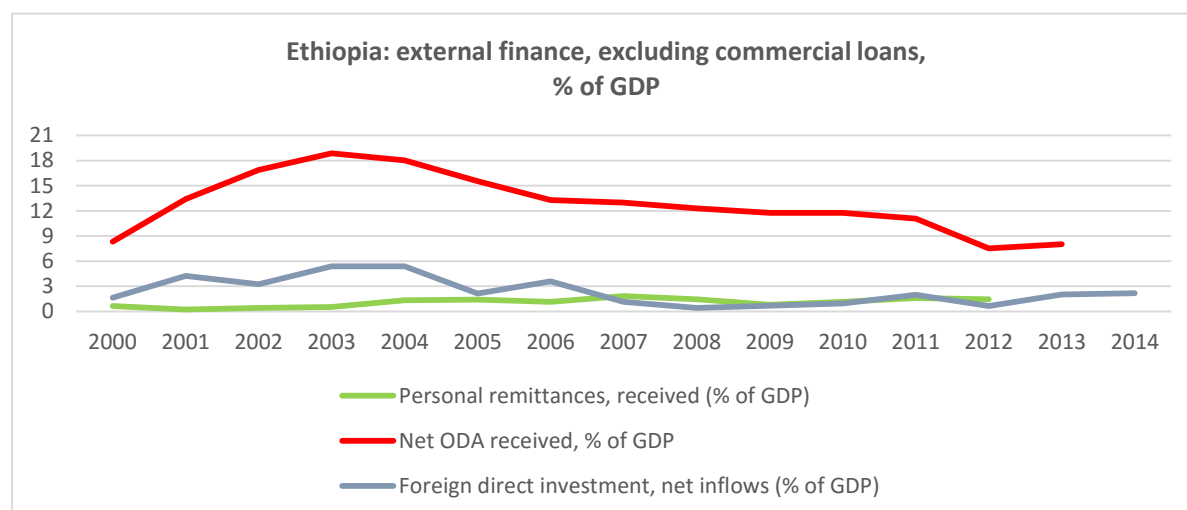


Source: World Development Indicators.

⁴ Data for the current account deficit differ between NBE and IMF statistics. NBE uses fiscal years.

The external deficit is financed with grants and preferential loans, foreign direct investment, remittances, and long-term commercial loans, mainly from China and Turkey (IMF 2012). Official development assistance shrank as a share of GDP, though not in absolute terms, to around 8% of GDP in 2013, while FDI (Foreign direct investment) accounted for 2% and remittances for only 0.7% (graph 12). Note that ODA (Official development assistance) in the form of grants lowers the current account deficit (and the budget deficit as well), in the form of loans it contributes to finance the current account deficit of around 8% (2014). Commercial long-term loans, mainly for state-owned large enterprises (Ethiopian Airways, Ethiopian Electricity Power, Ethiopian Telecom, Ethiopian Railway etc.) contribute to capital inflows of around 4-5 billion USD. Despite the high dependence of the country on foreign finance, external debt has not yet reached a critical point.

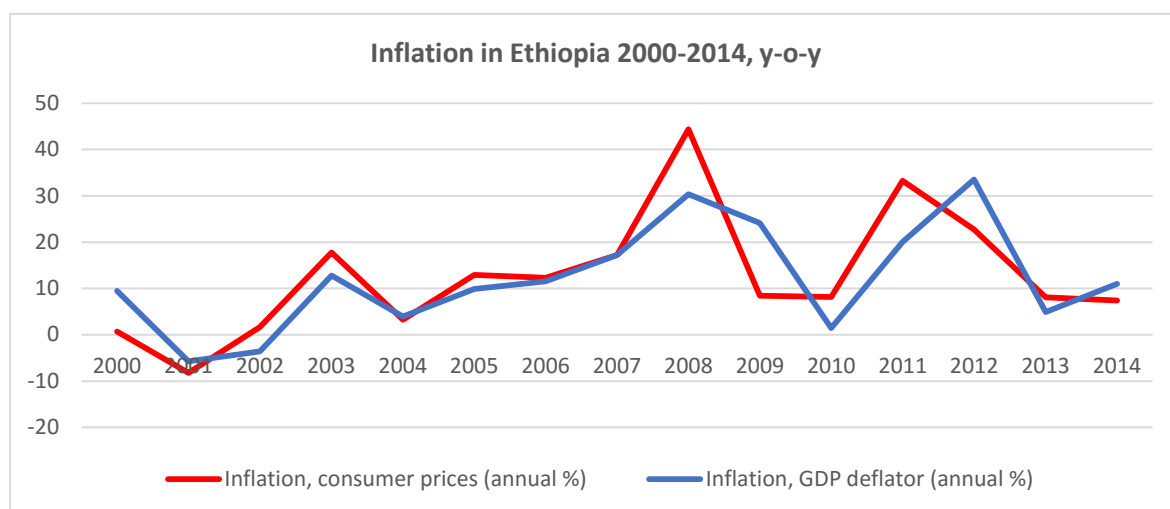
Graph 12



Source: World Development Indicators.

Inflation is an indicator of domestic macroeconomic equilibrium. Apart from two inflationary periods (one reaching upwards of 40% inflation) – 2008 and 2011/2012 – inflation rates remained in or close to single figures (see graph 13). Both inflationary peaks coincide with hikes in commodity prices on the world market. Food and energy prices have a strong bearing on domestic consumer price inflation.

Graph 13



Source: World Development Indicators.

We do not have accurate data on credit generated by the financial sector, comprising the central bank (NBE) and the commercial banks (including the three public banks, the Commercial Bank of Ethiopia with 34% market share, the Development Bank of Ethiopia and the Construction & Business Bank with around 10% market share, measured by capital, cp. NBE 2014, 50ff.). Since the NBE used at times direct monetary financing of the government, the role of domestic finance remains slightly opaque in this paper. What is clear is that domestic financing of government spending played a strong and increasing role for the creation of aggregate demand. This was supported by constant nominal lending rates of banks and low nominal deposit rates; in face of the inflation in the country, real lending interest rates were negative and real deposit rates highly negative. This feature of financial repression will be discussed in the next section.

After this broad and rough overview on Ethiopia's macroeconomic performance we will attempt to explain the main drivers for Ethiopia's growth in a narrative that is in line with the evidence shown.

3. An explanatory narrative – demystifying the “miracle”

Favourable conditions

As a very late latecomer, Ethiopia was blessed with *good initial conditions* for a relaunch of the entire economy. Time was more than ripe for a change in 2003 when growth started to unfold. GDP per capita had almost reached the same level as in 1983, eventually reaching

this goal in 2005, 22 years later. Our hypothesis is that there was (and perhaps still is) a great negative but unmeasurable and invisible output gap, or, in other words, a much higher level of potential output compared to actual GDP. This might be called a *backwater-effect*: knowledge and human capital are partially unused but keen to be used and put in motion. Most likely the two decades before were not entirely lost (because of missing data, a water-tight empirical proof is impossible). Education had likely improved, technical standards in production had been somewhat bettered, the stock of knowledge had risen, the population's age structure had become younger than ever, and high prospective population growth could be expected. There was a *potential* "demographic dividend" if the enlarged labour force could be employed – an open window of opportunities. Besides this, the need to somehow provide this group with employment was pressing for the government, since the wishes of millions of young people were at stake. Also Gerschenkron's "advantage of backwardness" had never been so big, since the rest of the developed and developing world had made so many advances in the past decades. Last but not least, the government decided to embark on a "big push" with a comprehensive strategy, reminiscent of the "developmental states" in Asia, which seem today almost outdated under the prevailing developmental philosophies in the track of the erstwhile "Washington Consensus" and many development-unfriendly rules in the present global economic order. Lastly, a severe drought had just been overcome.

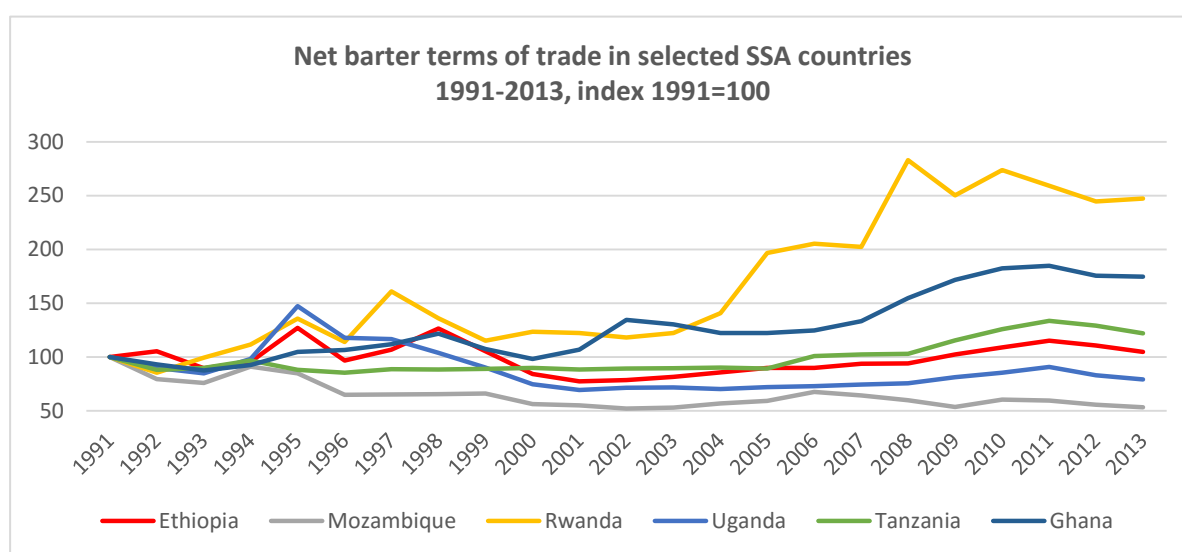
One feature of this initial-conditions-diagnosis is that the predominating subsistence economy was in considerable parts at the brink of being lifted into a market economy with money incomes and a higher degree of division of labour. The average poverty gap was only around 8% (World Development Indicators). At a certain threshold of economic development the tide comes and lifts all boats so that they can move forward in the water. What is needed is a strong impulse that can start a virtuous circle of growth and development.

The *external environment* for a virtuous circle was very favourable in the 2000s. During this time, the SSA countries experienced the best decade since a long time. That the tide would also reach the boats that lay dry for so long and lift them into water was quite likely. Among the positive external factors, the rise of the barter *terms of trade* stand out, mainly due to rising commodity prices. For Ethiopia the barter terms of trade rose by 42% from its lowest point in 2001 to its peak in 2012 (see graph 14). Rwanda was faced with rapidly rising terms of trade. Mozambique experienced a strong fall from 1991-2001, then subsequent stability

with only mild fluctuations. Ethiopia remained middle of the road when compared to its peer countries. It should be kept in mind that rising terms of trade have an ambiguous impact on growth, since they not only provide better revenues for commodity exports but also put pressure on consumer price inflation.

Another favourable external factor for Ethiopia – apart from the absence of severe droughts in the period analysed – was fairly high growth in the world economy until the global financial crisis in 2008. In particular, the emergence of China and additional emerging markets created new export opportunities and contributed to low-cost consumer goods which strengthened the terms of trade. Last but not least, Ethiopia as a large economy in terms of population in Africa has a favourable geopolitical stance, attracting attention from three competing super-powers (US, European Union, China), for political and partly also economic reasons (Hackenesch 2011). Since China has been faced with strong wage increases, especially after the financial crisis, the production of simple consumer goods will likely be relocated to low-income countries, be it in Asia or in Africa. Justin Lin, former chief economist of the World Bank, mentioned that China would shed 85million low-wage industry jobs over the coming years due to rising wages, whereas in 2011 Africa had in total only 10million jobs in manufacturing (Lin 2011). China’s presence in Africa heralds a change toward outward Chinese FDI, now beyond the traditional resource seeking type. Lastly, the late debt relief of 2006 should be mentioned as another favourable external condition.

Graph 14



Source: World Development Indicators.

Domestic determinants – from public investment to overall investment dynamics

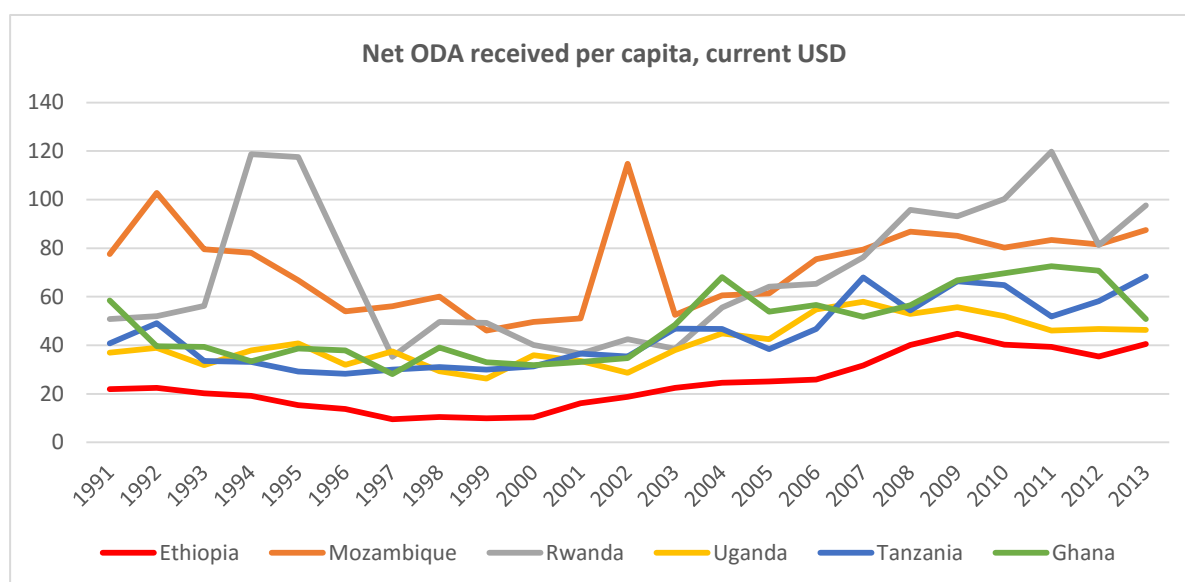
Let us come to the core of our narrative, the domestic factors pushing growth. The initial impulse for kick-starting growth came from the terms of trade reversal, as mentioned above, and massive public infrastructure investment. This caused a leap in aggregate demand, fuelled by higher income for commodity producers (chiefly in agriculture), by deficit spending including direct monetary financing of government spending, and perhaps also by the peace dividend received after the end of the war with Eritrea. Thus it was a mix of aggressive expansionary monetary policy and fiscal policy in order to reduce some of the most binding bottlenecks for growth: traffic infrastructure, telecommunication, agricultural extension service, electrification, education etc. Another factor, perhaps equally as important as increasing aggregate demand, was the targeting of expenditure on priority sectors. Channelling additional expenditures to fields which are normally not provided for by markets induced productivity enhancing changes of aggregate supply. Especially productivity increases in agriculture, affecting the lion's share of the labour force, via the use of more fertilisers, better knowledge with extension services, and better road infrastructure. These factors helped to surpass the threshold from predominant subsistence agriculture to small-scale marketing of the output. This process, a transition of the economic system toward a market economy, spilled over to the service sector, particularly commerce, hence kick-starting the growth of very conventional services. Multiplier and accelerator effects triggered construction industry and public utilities provision. The launch of huge infrastructure projects added to aggregate demand while supply effects came after the long construction period.

Kick-starting a public investment-led strategy meant doing the obvious: making good on what was neglected for so long through the provision of pro-poor public goods. This was the precondition for further development, especially in a vast land-locked country with a low degree of urbanisation, high logistics costs, poor electrification, and poor environmental quality of land.

Increased foreign aid helped somewhat to finance the necessary complementary imports of intermediate and capital goods needed in this strategy. Per capita ODA doubled from around 20 USD to 44 USD from 2003 to 2008 (and hovered around 40 USD later on) in the course of the boom period analysed, but remained much lower than in all other fast growing SSA countries (graph 15). Rwanda attracted three times the per capita volume and Mozambique twice that of Ethiopia's per capita aid. Ethiopia followed in this respect more or less the ad-

vice given by the advocates of the Millennium Development Goals (MDG), namely tripling aid, as proposed most vocally by Jeffrey Sachs in his MDG project for the then UN General Secretary Kofi Annan. MDGs are goals without explicit strategy. The implicit strategy can most likely be interpreted as pro-poor public-investment-led development, at least in low-income countries.

Graph 15



Source: World Development Indicators.

When the production boom gained momentum and turned into a virtuous self-reinforcing cycle, corporate investment started to unfold, be it investment of state-owned or private companies. What started as a public-investment-led growth acceleration turned into a full-fledged investment boom with around 37% share of gross capital formation in GDP, of which public investment shrunk to around 27% (of total investment) by the end of the period analysed. Thus growth became investment-led. However, the main dark side is that the manufacturing sector remained marginal with 4.3% of value added in GDP. Industrialisation grew quickly, but its share in GDP stalled, so that investment was booming in non-tradeable production, apart from agriculture and infrastructure. Investment in local power generation, however, has a prospective substantial import-substitution effect.

Expansionary monetary and fiscal policy

Expansionary monetary and fiscal policies were not contained to temporary pump-priming during the early years of the boom, but fuelled investment continuously. Monetary policy was geared to maintain negative real deposit interest rates and low real lending rates, but

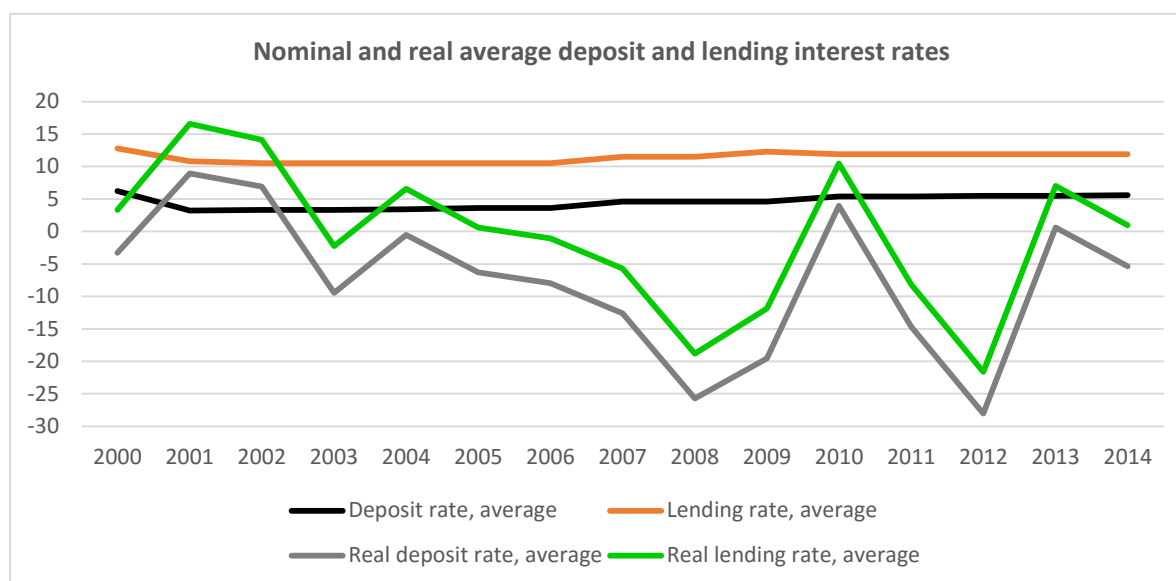
inflation rates are volatile and nominal interest rates should not replicate this volatility (graph 16). Nominal deposit and lending rates are assigned to commercial banks, with a broad band for the latter. It is not clear which tools the NBE intended to use to cope with inflationary pressures. Nominal interest rate fixing with open market policy is not practiced in the absence of a bond market and of a substantial interbank money market. Officially the NBE is committed to using base money control as a nominal anchor strategy (IMF 2012, 2015). This would be a belated replication of outdated money targeting; as interest rates are controlled, one has to assume that de facto credit rationing plus channelling to target sectors is applied. Using the exchange rate as a nominal anchor, perhaps in a crawling peg manner, is officially not declared, but may be in the mindset of central bankers who officially have announced managed floating. It seems to us that the NBE uses a pragmatic and variable policy to check inflation, at times with credit rationing, varying direct monetary financing of the public budget (to a small extent) or with selling/purchasing foreign exchange, i.e. by using foreign exchange reserves as a tool. The latter tool is limited in its usage for inflation control by the stock of reserves.

Whatever the NBE has done or intended to do, sometimes with harsh direct and distortive interventions, core inflation was kept under control at a tolerable though high level, apart from the two spikes mentioned. Apparently the NBE did not fight against these spikes in inflation, but rather chose to avoid second-round inflationary effects. Average real deposit and lending rates in the period 2000-2015 were -7.5% and -0.66% respectively.⁵ Overall, this is a highly expansionary monetary policy. However, the broad money/GDP ratio which correlates with the credit/GDP ratio remained more or less constant.⁶ Since commercial banks are compelled to purchase government bonds, complaints are raised that monetary policy crowds out private debtors (IMF 2015, WBG 2015). Scant data provided by the NBE show, for instance, that for 2007/8 the share of the central government in the stock of outstanding credit was 15%, and that of public enterprises was 18%, together making up 1/3 of aggregate credit (NBE 2007, 72), certainly no reason for deep concern.

⁵ NBE (2015, 48) assumes much lower inflation rates (headline) than reported by the IMF and World Bank and shown above in graph 12.

⁶ Based on NBE Annual Reports, with sometimes revised or contradictory data. Since 2007 M2/GDP hovers around 28% (NBE 2015), a low level in international comparison.

Graph 16



Source: NBE, Annual Reports, World Development Indicators, own calculations.

It seems to us that the Ethiopian authorities deliberately take into account that negative deposit rates indirectly subsidise low or even negative real lending rates and that the high spread between deposit and lending rates allow commercial banks to carry the burden of holding government bills with negative real interest rates. Maybe state-owned debtors are somewhat privileged, not least because their collateral is considered better because of government backing, as in many developing countries, especially in China. The NBE reported (2014, 57) that 44.5% of new loans were lent by private banks.

On the one hand, negative real deposit rates burden depositors with a quasi-tax on savings, on the other hand they benefit from rising incomes due to high growth. The idea that saving rates shrink in face of low or even negative interest rates (as asserted time and again by IMF reports and WBG 2015) had been rebutted by much empirical evidence in many countries and in many episodes. Saving rates may even behave adversely to low interest rates, as savers need to save more if they want to achieve the objectives for which they save. Benefits for debtors and the burden of depositors do not match each other; the former outweigh the latter. Due to the NBE's capacity for "fiat money" the balance sheet of the central bank may show losses, as liabilities might outstrip assets, but a central bank is not a private corporation.

Strict capital outflow (and inflow) controls in Ethiopia prohibit – as far as they are not by passed by illicit capital flows – the movement of deposits abroad. However, large state-owned companies with foreign exchange earnings are allowed and probably even encour-

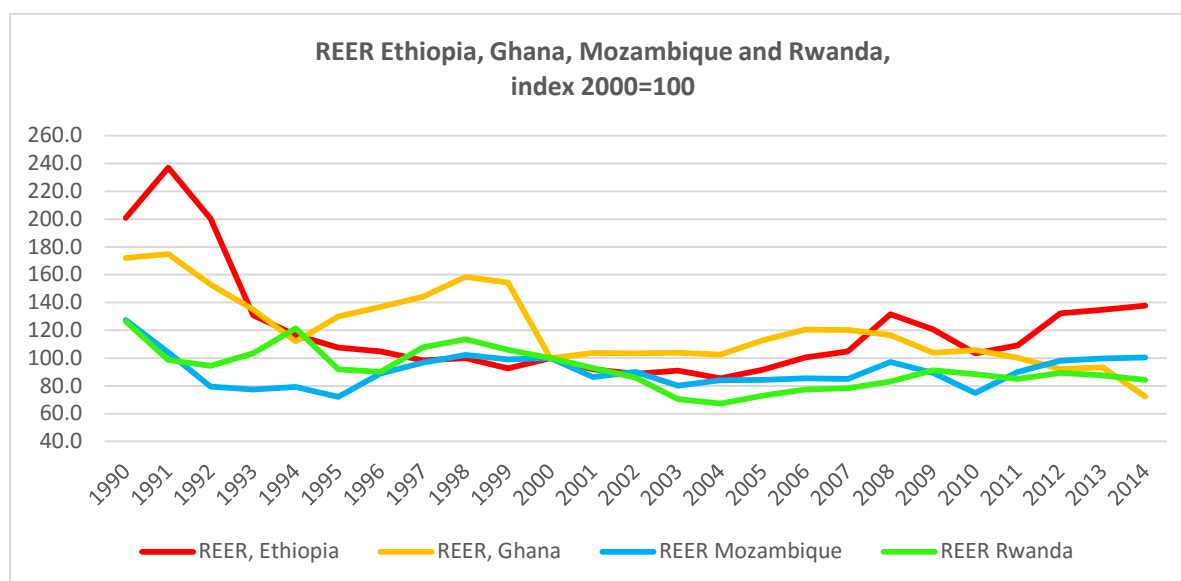
aged to incur long-term loans in hard currency from foreign creditors (with government guarantees). Despite a fairly liberalised trade regime, permits for imports have to be requested from the NBE (IMF 2015, 28).

The implicit philosophy of the Ethiopian authorities seems to be that small and medium enterprises should predominantly use their cash flow, mainly increased profits, for investment, while micro enterprises can use microfinance provisioning. This corresponds to reluctant lending practice, especially for longer terms and hence for investment, by many commercial banks in developing countries. The key reason is lack of collateral and legal enforcement opportunities of creditors' claims, apart from stable and foreseeable long-term real interest rates in face of volatile inflation rates. Summarised, banks consider lending to small and medium enterprises as too risky and tend to charge them with high risk premiums which are considered prohibitive by many debtors or even attract risk seeking investors who cannot be singled out by banks due to asymmetric information (Stiglitz 1994, 2000). Because of this problem, the notion to make use of the connection of state-owned banks and state-owned enterprises which enjoy an implicit guarantee by the government may not be a bad idea for monetising an under-monetised nascent market economy. China is the template for this strategy.

Real currency appreciation with ambiguous effects

Investment dynamics of the production of non-tradeables also benefitted from the overvalued real effective exchange rate (REER) which serves as a subsidy for imports, especially for capital and intermediate goods. Furthermore, inflation can be somewhat mitigated without severe tightening of monetary or fiscal policy. The unfavourable other side of the coin is that exports are hindered, as if they were taxed or levied with a tariff. A fairly high current account deficit with financial dependence from external donors and creditors emerged – growth with external imbalance. This ratio of tailwinds and headwinds holds only for the short or medium term. In the long run, appreciation needs to be corrected; in the course of subsequent real depreciation the former tailwinds become headwinds. Often real depreciations have temporary *contractionary effects*, while real appreciation may bring temporary expansionary effects.

Graph 17



Source: Bruegel 2016.

Ethiopia's REER appreciated by 55% from its low point in 2002 to 2014 (see graph 17). The REER-index presented here is based on exchange rates vis à vis 63 trading partners, using CPI data, calculated by the Belgian think-tank Bruegel.⁷ The appreciation of the Birr stands in clear contrast to the peers depicted in graph 16, Rwanda, Mozambique, and Ghana. Using the standard IMF methodology for the assessment of under- or overvalued real effective exchange rates leads to the conclusion that the REER is over-valued by 11-23% in 2012 (IMF 2012, 7f., 34) and by 30% in 2015 (IMF 2015, 14, 36).⁸ The external sustainability approach of the IMF external sector assessment shows 70% over-valuation in 2015 (IMF 2015, 36).

An economy like Ethiopia's, growing quickly out of subsistence, is likely to have a strong *Balassa-Samuelson effect* (normally this effect is included in the IMF assessment). Nominal incomes for non-tradeable production, starting from very low levels, grow faster than incomes in tradeable production. Parts of the appreciation might offset the statistical initial under-valuation of the real exchange rate because of the subsistence economy with cheap food prices. This effect does not necessarily affect the competitiveness of tradeables to the full extent of the real appreciation. But it is likely that real wages of workers in tradeable production fall if non-tradeable prices rise. Hence the wages in the tradeable sector tend to

⁷ Calculations of the REER by the NBE for 2007-2014 come to similar results (NBE 2015, 92).

⁸ The IMF CGER and present EBA methodology uses three approaches, the macroeconomic balance approach, the equilibrium REER approach, and the external sustainability approach. The first two diagnose for 2012 11% overvaluation, the third 23%.

adjust, more or less. The extent and relevance of the Balassa-Samuelson effect on the impaired competitiveness due to appreciation is unclear (cp. Rodrik 2008).

What caused the appreciation surge of the Birr? It was mainly the big inflation episodes in Ethiopia from 2008-2009 and 2011-2012 to which the authorities did not sufficiently counter with equivalent levels of depreciation. They were most likely more afraid of inflationary depreciation than of losing competitiveness. Tight monetary or fiscal policy would have likely choked off the growth boom, to some extent.

Furthermore, it seems that benefits from appreciation, e.g. lower import costs, especially for capital goods which boosted fixed investment and even promoted importation of consumer goods, and lower costs for debt payment in local currency, outweighed the disadvantages. All in all, the impediment of growth by appreciation was overturned by boosting domestic demand. The appreciation surge diminished export earnings and the benefits from higher world market commodity prices, since for every dollar earned less local currency units are received. This way, the appreciation is an enormous hurdle for industrialisation; it is probably a key reason for the failure of further industrialisation (in the sense of rising manufacturing value added shares in GDP). In this regard the whole investment-led strategy has a point of high vulnerability and stands in stark contrast to above cited early pioneers of development economics calling for a “big push” – but *with* industrialisation. Yet, one should be reluctant to see a clear and unambiguous link between growth and REER performance. After 1991 Ethiopia devalued the REER heavily, coming down from highly overvalued exchange rates. But there was no remarkable growth dividend.

Let us now look how severe the imbalance in the balances of payments really is. So far, external debt could be carried by the debtors without impeding growth or risking financial stability. The budget deficit is amazingly small, on average only 3.3% in the period 2000-2015 (IMF 2016), ranging from a peak of 8.9% in 2000 to a low of 0.9% in 2009. The grants in the budget account for around 6.5% of expenditure (2014) which is only 1.15% of GDP. Assuming that the budget deficit is fully financed with external finance, then 3.3 percentage points of the current account deficit of 8.0% in 2014 (hence 41% of the current account deficit) is caused by fiscal deficits, and the rest by corporate debt, most likely predominantly by state-owned enterprises. Interest and principal repayments make up no more than 1.4% of GDP for 2014 (NBE 2015, 85, based on Ministry of Finance and Development). Maturity mismatch is not a problem as short-term debt has only marginal impact. Obviously this imbalance in

the current account until 2014/15 is not of great concern (see also IMF 2012, 2015), but may be a risk in the future should the external environment be exacerbated (commodity prices, global growth etc.).

What underscores this sanguine assessment is the fact that the nominal as well the real growth rate of the economy outstrips (nominal and real likewise) interest rates on external debt, but also regarding domestic debt. Chronic primary deficits in government budgets can be carried without jeopardising debt sustainability. The country grows faster than the debt burden. However, whether future external debt can be incurred under similarly favourable conditions is uncertain.

It is clear from this diagnosis that further high growth without marked improvements in exports is only possible if more external debt, commercial or preferential, is incurred even if the current account deficit remains stable (relative to GDP). To avoid this risky trajectory, a turnaround in the trade balance requires real depreciation and industrialisation, the latter being announced in the GTP, the former not.

Bottom lines

Let us now summarise the bottom lines of our narrative. Positive initial conditions had most likely generated a considerable unexploited output potential. A favourable external environment, first and foremost high growth in the world economy until 2008 and increasing commodity prices with a terms of trade boom for Ethiopia, induced a strong tailwind for growth. Yet, the main determinants for the growth boom were continuous expansionary monetary and fiscal policies which boosted aggregate demand, together with the terms of trade. It was mainly the mobilisation of domestic finance used for public-investment-led growth which evolved into general investment-led growth with a very high investment-to-GDP ratio.⁹ The engine of growth is well-targeted fiscal policy and also targeted monetary policy. The latter is a variant of “repressed finance” that facilitated low real lending rates, even negative in heavy inflation years, at the expense of negative real deposit rates; domestic finance and hence aggregate demand was channelled into comprehensive infrastructure projects, with pro-poor and pro-agriculture priorities. The well-known nexus of public banks and public enterprises were the initial engine of growth, inducing multiplier and also accel-

⁹ As an example, the Grand Ethiopian Renaissance Dam project on the Blue Nile River was fully financed domestically, media report.

erator effects. These affected investments of private and public enterprises too, so that meanwhile only one fourth of total capital formation stems from public expenditures.

Fuelling aggregate demand spurred aggregate supply growth, especially by spurring technical progress in agriculture which in turn accelerated the over-due transition from subsistence agriculture to a market economy. Progress in agriculture spilled over to the service sector and those parts of industry which produce non-tradeables, in particular infrastructure, housing and utilities. Bulging investment fuelled employment and wages, and subsequently household consumption. A virtuous domestic-demand-led circle emerged, unimpeded by too tight monetary or fiscal policy. The authorities accepted a high dose of inflation tolerance, in face of food inflation, partly imported from world markets, and also in face of bottleneck-inflation, to some extent unavoidable in a nascent market economy.

The growth boom is overshadowed by neglect of inflation offsetting depreciation of the currency, inducing strong real appreciation which impeded exports and industrialisation with a focus on manufacturing.

For the most part, the Ethiopian scenario of growth is fully in line with Keynesian and structuralist concepts of development, such as the big-push strategy of most early development economists, Kaldor's notion of demand-induced technical progress, Prebisch and Singer's understanding of the key role of the terms of trade and the quest for pro-poor growth with tripling aid by Jeffrey Sachs and MDG proponents like Kofi Annan. It incorporates a positive view on financial repression adopted in China and other Asian success stories (cp. Stiglitz 2000), including a positive view on the role of public banks and public enterprises, contrasting the late "Washington Consensus".

What is not at all in line with these authors or country experiences is the neglect of industrialisation and related promotion of industrial policy with an appropriate exchange rate policy that avoids appreciation and calls for mild under-valuation (cp. Rodrik 2008 representing many others, also Priewe/Herr 2005, Frenkel/Rapetti 2015). Instead of real exchange rate undervaluation, normally seen as an integral part of "financial repression" and key for heterodox approaches to development, the opposite is implemented. This should be the task assigned to GTP II, although the key elements are missing – an up-to-date concept for industrial and monetary policy with real exchange rate management that supports international competitiveness. The past decade was *in this respect* closer to very conventional neoclassical wisdom of a "natural" saving gap and a concomitant net resource transfer from rich to poor

countries, which includes overvalued exchange rates. Ethiopia's growth concept is – despite its grand success – not yet coherent; it needs fundamental changes (cp. Rodrik 2014).

The growth acceleration of Ethiopia is unique. Even though Rwanda's and Mozambique's growth in the period analysed here is only two or so percentage points lower, their growth stories are different (UNCTAD 2015). As to our knowledge, Ethiopia is the only country in SSA and perhaps even worldwide which grew to a remarkable extent out of subsistence agriculture with the combination of public investment and positive terms of trade and without special natural resource endowments. A key ingredient of this unique strategy is the resuscitation of the idea of a "developmental state" (although the term is not used in Ethiopia, but "state-led" development is very similar) which guided successful Asian countries like Japan, Taiwan, Korea, China, and Vietnam to a sustained high growth trajectory.

4. Alternative theoretical and political approaches

A basic neoclassical model would explain a period of take-off and high growth by exogenous technical progress (or total factor productivity increase TFP), for instance in agriculture, that spills over to the industry and service sector. This can be modelled with a production function in a purely supply-sided approach. Furthermore, demographic changes that provide a "demographic dividend" with a high share of working-age population and a low dependency rate would improve real output, if full employment (with equilibrium unemployment) is presumed. Also static reallocation of factors of production may reinforce TFP, e.g. if labour shifts from low to high productivity sectors. Increased saving, due to changes in time preference, is channelled automatically into more investment as saving rates are seen as a positive function of interest rates and fixed investment as a negative function of interest rates. The flow of savings in a period determines the flow of credit, following the conventional loanable funds theory. There is no role for fiscal policy except providing necessary public goods, preferably financed by tax revenue; some counter-cyclical fiscal policy for smoothing growth fluctuations might be conducive, but would have no bearing on the growth trend. The central bank should control money supply and hence inflation, and nothing else. If a country has strong preference for consumption, investment will outstrip domestic saving, hence foreign saving will be demanded and net resource flows will be generated in a global market economy with free capital mobility. Under a regime of "good business climate" and "good governance" foreign direct investment from rich countries is attracted by higher marginal

productivity of capital. This allows a long-standing equilibrium current account deficit and shapes the corresponding equilibrium exchange rate.

Key ingredients of this theoretical framework can be found in “The Great Run” from authors of a World Bank research project (WBG 2015). The authors attempt to explain Ethiopia’s unique growth in an entirely supply-sided framework. Aggregate demand is an ousted term. Implicitly it is, however, an important ingredient and a necessary key for their explanation. They identify public investment policy as the main driver for TFP acceleration, initially and over the entire period until 2014. Additionally, the “demographic dividend” is mentioned, although this would increase only *potential* output unless labour demand increases, and a positive external environment, hence strong demand dynamics. It is correctly contended that infrastructure policy was financed in important parts by “heterodox macro-financial policies”; but the latter are heavily criticised. Yet, would public investment have occurred without this policy? And isn’t such financing increasing aggregate demand, and the positive external environment with increasing terms of trade and buoyant world conjuncture too? Even though the authors appreciate Ethiopia’s “Great Run”, they argue the run came *despite*, not *because* of the “heterodox” policies which tend to be inflationary, crowd out private investment, distort real interest and exchange rates etc. When it comes to policy proposals, they recommend three “policy adjustments”.

The first goes for alternative infrastructure financing, mainly by taxes, fees and prices (e.g. higher electricity prices), higher real interest rates which would induce higher saving of households, developing capital markets and securitised assets etc. This follows implicitly the loanable funds theory. In contrast, modern monetary theory (from a neoclassical point of view “heterodox” theory) argues – with strong theoretical and empirical backing – that deposits are the *result* of generating credit and income, and saving is not a limitation for finance. Finance is *created* at will (“fiat money”) by the banking system if credit demand exists.

The second “policy adjustment” proposes widening credit markets for private investors rather than crowding them out, mainly by the first policy proposal with higher real interest rates, assuming, again, that the latter incentivise savers to save more. If this implies positive real interest rates, real lending rates would rise considerably – and likely *deter* private investors.

The third policy reform calls for “structural reforms”. The authors surprise readers by stating that Ethiopia’s strategy has not brought “structural reforms”. Public investment, electrification, road construction, leaps in agricultural productivity – no structural reforms? They don’t mean the failure of industrialisation. Their understanding of “structural reform” is shaped by neoclassical theory – it is sequenced liberalisation of trade, of the financial sector (implying abandoning “repressed finance”), and liberalisation of the capital account. Apart from trade, the other two policies are already key pillars of the Ethiopian GTP policy, and key pillars of all successful Asian top growth runners. Interestingly, industrial policy is not on the report’s agenda. Nonetheless, the authors admit that Ethiopia’s public investment policy has been a unique strategy that can go a long way in poor countries.

The IMF Country Reports on Ethiopia (e.g. IMF 2012, 2015) articulate similar ideas and comments to the authors of “The Great Run”. IMF authors are concerned about public borrowing (suspected to crowd out private borrowing) and criticise direct NBE financing of the government budget (although this is only around one percent of GDP). They complain about too much leniency in the face of high inflation, and hence call for tightening interest rates and fiscal policy; by contrast, they consider the fiscal deficit, lower than 3% most of the time, as sustainable. Commercial banks should not be obliged to purchase NBE bonds (for channeling finance to the state-owned Development Bank of Ethiopia). The overvaluation of the currency is seen as critical if external risks would increase. Interestingly, while GTP II wants to achieve 11.0% growth p.a. 2015-2019, the IMF Report proposes a scenario with 7.7%, but with an even *higher* current account deficit (14% rather than 12.3% in the GTP II, cp. IMF 2015, 11), since the consumption share in GDP is supposed to be higher and the investment share lower. “Repressed finance” does not fit into the authors’ mindset.

Lastly, we look into UNCTAD’s recent “Least Developed Countries Report” from 2015 in which policy options for poor countries hoping to reach the “Sustainable Development Goals” (2030) are analysed. UNCTAD does not focus on specific countries but highlights pro-poor reforms necessary to eradicate poverty. On average for the group of Least Developed Countries (LDCs), consumption per capita has to double, especially in rural areas (and hence in agriculture) where the vast majority of the poor live. The report emphasises the role of public infrastructure in all its components. Malnutrition has a strong impact on productivity and causes enormous opportunity costs (see also FAO 2014 and Hoddinott 2013). Proximity to urban areas is important for marketing, growing out of subsistence and earning nonfarm

income. As 35% of the Ethiopian population still suffer from malnutrition – coming down from 58% in 2000 and 50% in 2003 when growth accelerated (World Development Indicators) – with some 7 million people with permanent need for public food support (Zerihun et al. 2014), there is a great need for further pro-poor infrastructure and extended staple goods production (see also the analysis of Wesenbeeck et al. 2009 on hunger and malnutrition in SSA with a strong focus on Ethiopia). UNCTAD’s report comments only marginally on macro-economic issues. They call for doubling foreign aid for LDCs. The LDC-Report 2015 does not address industrialisation, however this is done in UNCTAD’s recent “Technology and Innovation Report”, with a chapter on Ethiopia’s strategy (UNCTAD 2015a, 75-92).

5. Conclusions

Our analysis of the causes of Ethiopia’s growth “miracle” has underscored the role of public infrastructure expenditures and related investment; in the course of the 12 years analysed, fixed investment swelled up and went far beyond infrastructure. The progress in reaching key developmental goals is stunning and unique for one of the poorest countries in SSA. Reinforced by rising commodity prices, rising terms of trade, and other favourable external factors (including doubling per capita aid, access to favourable non-concessional loans from China, and high growth in the world economy) Ethiopia’s strategy could channel aggregate demand increases into priority areas and transform this into technical progress. “Repressed finance” with some heterodox elements was a necessary precondition for growth, including low or at times negative real lending interest rates.

Industrialisation progressed only in non-tradeables, i.e. construction and production of utilities. These sectors generate important positive external effects for small-holder peasants, commercial farms, and enterprises. They are key ingredients of improvements in the “business climate”, a broad term embracing many different aspects. Manufacturing did not make headway. The share of manufacturing value added in GDP is – with 4.3% in 2014 – the third lowest from 21 low-income countries with data, only Chad and Sierra Leone perform worse. Ethiopia had reached just half of the average of low-income countries in 2014 (8.8%, data from World Development Indicators). In the group of lower-middle-income countries only small islands and a few other countries have a share similar to Ethiopia, the latter mainly resource-rich countries. Ghana is one of the few countries in this group with less than 6%, having halved manufacturing in the course of the commodity boom in the 2000s. Average

share of manufacturing among lower-middle-income countries, excluding small islands, is almost 13% of GDP (2013), for 39 reporting countries.

With an unfavourable real effective exchange rate Ethiopian manufacturing has almost no chance to become competitive, neither for exports nor against imports, given a liberal trade regime. The government's industrialisation strategy is focused on establishing "industrial parks", similar to free trade zones for foreign and domestic enterprises, with subsidies and different forms of preferential treatment (Gebreeyesus 2013, Assefa 2010, UN Commission for Africa 2016, UNCTAD 2015a). Experience with this type of industrial policy in Africa and elsewhere is sobering. Concepts for advanced and more aggressive industrialisation, learning the lessons from Asia and from developed countries, differ considerably (cp. Wade 2015, Rodrik 2007, Altenburg 2011). Integrating in global value chains may be a first step, even though forward and backward linkages are mostly limited and companies on top of the value chain benefit most as they can exert strong monopsony-based market power (cp. Cattaneo et al. 2010). The fact that the share of the cut-flowers retail price in Europe which is attained by Ethiopian exporters is around 2% and for specialised coffee is 7%, is not very encouraging (Zerihun et al. 2014, Belwal/Chala 2008). Development with specialised agriculture or service exports was historically insufficient for successful developing countries. For upgrading Ethiopia to the middle-income class, the country is condemned to a strong push in industrialisation (Rodrik 2014). This requires a clear shift in exchange rate and monetary policy in the direction of exchange rate targeting at a level that enables exports (cp. Frenkel/Rapetti 2015). GTP II falls far short of this requirement. Ethiopia is in a similar situation to China in 1994 when two inflationary surges in the late 1980s and early 1990s led to a marked overvaluation. Chinese authorities managed a 50% devaluation in one leap in 1994 without much inflationary pass through and kept the currency almost constant at this level until 2005. Of course, China is certainly not a model for Ethiopia, but the country must not shy away from the challenge.

One might question whether a country like Ethiopia, remaining on a very low income level, can or should embark on massive industrialisation – or postpone this ambitious project and focus instead for the medium term on improving agriculture and infrastructural conditions for industrialisation such as electrification etc. There can be no doubt that widespread absolute poverty and malnutrition, particularly the shortage of micronutrients, are extremely costly on all counts as physical and mental capabilities are inhibited. Reducing malnutrition

has a great potential to raise labour productivity and the quality of education (WFP 2013). Investing in food with mainly home-made resources can spur technical progress, aggregate supply and aggregate demand. Further tapping this potential with high priority may be an alternative to quick industrialisation for the medium term. On this route, structural change would be slowed: production of more staple food and other agricultural products would have top priority. Market-driven structural change would be postponed, since an important part of the population is still excluded from markets. Thus, nutrition for everyone is a kind of public good with great positive external effects.

However, if taking this path the external imbalance is likely to remain large, requiring external finance as in the past, or perhaps even more. Promoting manufacturing should be continued, but the change of course toward massive industrialisation and real currency devaluation would be postponed for five or so years, including the correction of the exchange rate. At this stage, we leave this question open to further debate. Managing two priorities at the same time seems hardly feasible.

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Imprint

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ISSN 1869-6406

Printed by
HWR Berlin

Berlin June 2016