Chapter 12
The Impact of Devaluation on Balance of Trade:
The Case of Ethiopia

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ABSTRACT

The aim of this chapter is to investigate the short and long-run impact of devaluation of the trade balance of Ethiopia. Devaluation has been used as a measure to improve trade balance. The data was collected from the World Bank for the years 1990 to 2017 and analyzed by applying an Autoregressive Distributed Lag (ARDL) approach and an Error Correction Model (ECM). The empirical findings show that the long run Real Effective Exchange Rate (REER) significantly and negatively correlated with the trade balance. The error correction coefficient which shows the adjustment of disequilibrium in the subsequent year is also significant. The empirical result indicated that devaluation of the Birr can improve the trade balance of Ethiopia. However, in reality, the trade balance of Ethiopia is not improved through a consecutive Birr devaluation. This may be resulted from the non-responsiveness of import to devaluation of the Birr, shortage of import substitute domestic products and the dependency of exports on primary agriculture products.

INTRODUCTION

In the globalization era, countries in trade deficit are applying different measures to adjust their trade deficit. Among these measures, devaluation is one of the well-known methods to improve trade deficit. The relationship between balance of trade and devaluation has been explaining by J-curve effect and Marshall-Lerner Condition. The Marshall-Lerner condition implies that if the sum effect of elasticities for import and export is greater than one, devaluation of local currency will improve trade balance in long-run (Bahmani-Oskooee, 1991). J-curve effect is used to explain the reduction and gradual corrections of a country`s trade balance deficit as a result of home currency devaluation. This effect may be derived from the low level of import and export elasticity immediately after the times of devaluation and higher over some time. Among the reasons of low elasticity after devaluation is the unfinished process of pervious imports and exports. It may need time to adjust imports and exports based on the revised exchange rate (Hacker & Hatemi, 2003).

The J-curve effect holds that a country's currency depreciation causes its trade balance to deteriorate for a short time, followed by a flattening-out period, and then a significant improvement occurs for an extended period. When a country's currency depreciates against the currencies of major trading partners, the country's exports tend to rise, and imports fall, which improves the trade balance. In the short run, however, a country's trade deficit may deteriorate just after its currency depreciates, because the higher cost of imports will more than offset the reduced volume of imports (Kim & Kim, 2006).

Ethiopia is one of fastest growing country in the world. The economy of Ethiopia is depending on agriculture and primary agriculture products are the main source of export income. Even though, the trade balance of Ethiopia is in deficit for serval years, the Ethiopian government is trying to improve the quality and quantity of export by taking different measures. The measures include devaluation of home currency (Ethiopian Birr), eliminating export taxes (excluding coffee), financial supporting to exporters, liberalization of international trade, launching of different export incentives and declaration of an opened investment law with several encouragement actions (International Trade Center, 2001).

The main aim of this chapter is to investigate empirically the short run and long run effects of birr devaluation on Ethiopian balance of trade. This means to assess the existence of Marshall-Lerner condition and J-curve effect in Ethiopia after the end of the socialist Derg regime fixed exchange rate system. The national bank of

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