PRIVATE SECTOR DEVELOPMENT IN ETHIOPIA: TRENDS, CHALLENGES AND POLICY ISSUES

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SUMMARY:
This publication narrates the summary reports of PRIVATE SECTOR DEVELOPMENT IN ETHIOPIA: TRENDS, CHALLENGES AND POLICY ISSUES of Ethiopian Economics Association project under the finance support from European Union.

EXECUTIVE SUMMARY

Ethiopian economics association is pleased to present this policy brief extracted from a fully- The role of the private sector in driving sustainable and inclusive growth, poverty reduction, and creating jobs in developing countries is indispensable. In Ethiopia, private sector has played a leading role in the structural transformation process towards industrialization and hence, has been given much emphasis in several national policy documents over the last two decades. In order to effectively use the opportunities available for sustainable development and transformation of the Ethiopian economy and to further leverage the private sector, it is important to examine the structure and performance of private sector development, identify important bottlenecks and challenges, and further investigate its contribution to the economy over the last three decades.

2. Rationale for Action

Despite policy support over the last two decades made by the Government of Ethiopia (GoE), the contribution of the private sector to the national economy as compared to the public sector is less satisfactory. The economic growth that the county registered in the last decade has been largely driven by public investments such as transport, energy, and social services (EEA, 2015; WB, 2016b). Consequently, the share of public investment in GDP increased from 5 percent in the early 1990s up to an average of approximately 15 percent in 2018/2019 (Mulu, 2019). Such types of huge public investment might complement private sector development or "crowding in" effects due to the expansion of crucial infrastructures. At the same time, it might also create "crowding out" effects due to the shortage of loanable funds and foreign exchange at the central bank (WBa, 2016). Therefore, to identify the key macroeconomic determinants of private investment in the country, more information is required on these factors. In addition, the private sector is predominantly characterized by small-scale, informal, and service sectors oriented mostly operating in domestic markets and not vigorously entering the productive sectors (manufacturing and agriculture) and the export market (Mulu, 2019). This indicates a need to identify weaknesses and constraints and thereby improving the country's export trade competitiveness and building its capacity of resilience to shocks.

3. The Main Body of the Text

Since the early 2000s, the government has implemented successive policies and strategies that promote private sector development in the country. In response to these, increment trends of the private sector investment projects (both domestic and foreign) have been observed from 2003 onwards. However, the majority of the investment has been carried out by domestic investors. The implementation rate of projects in all development plan periods has been very low and showed a decline in the agriculture sector investment from 2000 onwards. Over the last three decades, the leading sector in terms of total capital inflow in the private sector investment (domestic and foregone) is the service sector. The industry follows the service sector while lower investment projects were observed in the agriculture sector.

Although promising signals that the industry sector has begun to emerge over the last recent years but with less participation of domestic private investors in the manufacturing sub-sector and with no or little agriculture sector investment indicating a less nascent structural change to wards to the productive sector of the economy. The policy lesson from GTP I and II suggests to scale-up the supports given to the manufacturing sub-sector for agriculture is crucial in the years to come. Balanced policy support for the productive sector between the manufacturing and agriculture sectors, with special attention to the manufacturing sector, is crucial during the current TYDP periods. Moreover, domestic private sector investment has not yet been channelled into the productive sector (agriculture and manufacturing) and export market, which has a trickle-down effect towards industrialization and structural transformation of the economy. On the other hand, in terms of creation of employment opportunities, the leading sector is the service sector. However, declining trends in permanent employment opportunities were observed over the last three decades. Hence, the private sector plays less satisfactory role in employment generation, export, and economic growth of the country.

The study identified key constraints and challenges hindering the domestic private sector from entering the productive sectors, export market, and stimulating greater private sector investment in the economy. The key constraints and challenges include: 1) inadequate physical infrastructure (that is, electricity, transport and logistics, and water supply services), 2) restricted access to input markets (that is, lack of access to financial services, limited access to land, lack of technically skilled labor force, and lack of raw materials), 3) shortage of foreign exchange, 4) weak institutional framework (that is, ineffective regulatory environments, malpractice in the informal market, corruption, custom, trade, and tax-related issues), and 5) Political unrest and prevalence of COVID-19 pandemic are the fundamental causes for the constraints of private sector investment in Ethiopia.

The ARDL model revealed that real effective exchange rate and credit have positive and significant effects both in the short and long run. On the other hand, government expenditure and real interest rate were found to be positive and significant only in the short run.

4. Conclusion

The study assessed the structure and performance of private sector development and identified the key constraint and challenges, and explored its contribution to the economy using secondary data and evidence from the past three decades. The study analyzed various policy measures designed by the government in response to promoting private sector investment in the country. An increment trend in private investment projects (domestic and foreign) has been observed over recent years. However, the majority of investment is owned by domestic than foreign investors. Besides, the implementation rate of projects has been very low across all plans and has particularly declined in recent years. The top three leading sub-sectors in terms of capital inflow made by the private are real estate from service, mining, and quarrying from industry, and agriculture, hunting, and forestry from the agriculture sector. Similarly, in terms of employment creation, the service sector remains the major contributor, followed by industry and agriculture in their respective order. However, the trends of permanent employment share declined over time sector over the last three decades. This implies domestic private sector has not yet vigorously entered productive sectors (agriculture and manufacturing) of the economy. The main constraints and challenges hindering private sector investment include inadequate physical infrastructure, lack of input markets, weak institutional framework, political instability, and the prevalence of the COVID-19 pandemic. On the other hand, the model result shows real effective exchange rate, amount of credit, government expenditure, and real interest rate are the main determinants of the privet sector investment in Ethiopia. The overall result shows the private sector plays a less satisfactory role in the employment generation, export, and output growth of the country.

5. Policy Recommendations

The government should scale up the policy supports given to the manufacturing sector during GTP I and II to the agriculture sector, and quickly address the constraints to improve private sector development by designing various short and long-term strategies to allow much greater role for the private sector in driving economic growth and job creation in Ethiopia. In view of these, the government should undertake the following main activities:

- Create enabling business environment by providing a range of incentive schemes in the priority sector of the economy;
- Resolve the bottlenecks through better functioning of input market (labor, land, and capital) through undertaking reforms in the financial sector, enhancing coordination within and between different layers of the government, and improving skillfully human resource shortages through continual capacity-building training; providing quality physical infrastructures and supplying modern, affordable and sustainable energy, providing and facilitating required raw materials and pieces of machinery, strengthening inclusive Public-Private-Partnerships (PPP) by providing preferential support for accessing raw material inputs, technologies, and financial services, and creating enabling business environment in the industrial parks;
- Ensuring consistent management strategies to minimize corruption, minimizing the violent uprisings by strengthening ways for ensuring peace and stability and building up the confidence of private sectors, and minimizing bureaucratic inefficiencies in the government and financial institutions;
- Providing all-round support to protect the private sector investment from the adverse effect of the COVID-19 pandemic through developing short and long-term adaptation and recovery interim plans;
- Government expenditure should be made priory on high-impact investment (such as preferably on physical infrastructure and development of industrial parks to stimulate private sector investment in Ethiopia;
- Real interest rate should be adjusted in such a way that encourages saving and private sector investment in the years to come;
- Undertaking government expenditure on capital investment (such as preferably on physical infrastructure and development of industrial parks);
- Provision of adequate financial service and undertaken reform will leverage private sector investment in Ethiopia;
- Provide various economic incentives for the domestic investors engaged in productive sectors that will help produce excess supply to improve the trade balance of the country; and
- Macroeconomic policies should be aligned with the comparative advantage of the country.

6. References

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