

Addis Ababa University
School of Graduate Studies
School of Business and Public Administration

Devaluation of Birr and its Impact on Firms which Operate Foreign Trade

(The Case of Quarit Agro Industry and Belayneh Kinde Import and Export)

A Project Submitted to the School of Graduate Studies of Addis Ababa University in Partial Fulfillment of the Requirements for the Degree of Master of Business Administration

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C E R T I F I C A T E

This is to certify that this project work, “Devaluation of Birr and its Impact on Firms which Operate Foreign Trade

(The Case of Quarit Agro Industry and Belayneh Kinde Import and Export)”, undertaken by Tewabe Gashaw for the partial fulfillment of Master of Business Administration [MBA] at Addis Ababa University, is an original work and not submitted earlier for any degree either at this University or any other University.

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Acronyms

1. BKIE: Belayneh Kinde Import and Export.
2. QAI: Quarit Agro Industry.
3. GPM: Gross Profit Margin

Abstract

By taking two import and export firms, this study assessed the impact of devaluation of birr on performance of firms. The study used both primary (collected through interview) and secondary data collected from financial statements of the two case companies. It is found that the devaluation has affected the firms in many ways such as requirement of large amount of capital, decrease in profitability, decrease in reliability of customers, etc. Gross profit margin on sales has decreased for both firms in the years between 2007 and 2009.

Key words: devaluation of birr, import and export.

CHAPTER ONE

INTRODUCTION

1.1. Background of the Study

It is obvious that firms engaged in foreign trade cannot perform their business with a single currency. Their business depends not only on the currency of their country but also on its relative price in relation to other foreign currencies. Birr is nowadays continuously depreciating in relation to dollar and other foreign currencies. This devaluation has a great impact on import/export firms.

A depreciation in exchange rate affects exporters' return positively making export more profitable which in-turn may encourage firms to increase volume of export. On the other hand, depreciation decreases the profit of import firms leading them to decrease the amount of their import (Alam, 2010).

With domestic prices remaining sticky, importers were able to earn more from their cheaper imports before the devaluation. Exporters on the other hand were subjected to pay more in the local market and sell their export items for prices that have not increased as high as prices in the home market in birr. As a result, birr was devalued from 2.07 to five against dollar in the early 1990s. Since then the purchasing power of the Birr continued to decline against the Dollar.

In recent years, the exchange rate has shown a marked double-digit rise for the first time in Ethiopia. If we consider only the recent two years, we can see a remarkable devaluation of birr.

On January 15, 2009, the dollar was selling at a rate of 10.6779 Br and buying at 10.4685 Br. However, the rate dramatically went up the next day to 11.2201 and 11.0001 Br, respectively. Two weeks before, a dollar was trading at 9.95 Br on the official exchange market, meaning that the Birr has depreciated by 11pc in nearly 15 days, (Fortune, January 15, 2009 edition).

Further, the country devalued its currency, the birr, 9.9 percent against the dollar on July 10, 2009 after difficulty in obtaining foreign exchange led to shortages of imported goods such as auto parts and medical supplies.

The country's official exchange rate fell to 12.444 against the dollar from 11.3247 on July 9, 2009. Currently, on average, a dollar is being exchanged for more than 13.75 birr on the official exchange market.

1.2. Statement of the Problem

Firms which are engaged in import-export business are highly concerned with the movement of the exchange rates of their currency against currencies of countries in which they are aligned. It affects their performance in general and their profitability in particular to a large extent. Generally, the appreciation of a given currency will favor importing firms and the depreciation will favor exporting firms in a country.

Birr, the Ethiopian currency, has recently shown a remarkable devaluation against dollar. The current devaluation of birr in relation to other currencies has many impacts on the performance of many import/export firms. The exporters are affected since the purchasing cost for their

exportable items increases. The importers are also affected by devaluation because they need large amount of birr in order to get a small amount of dollar.

Considering these problems the study assesses the impact of the devaluation of birr on the performance of import and export firms. The study took two import/export firms: Quarit Agro Industry (QAI) and Belayneh Kinde import export (BKIE) as case companies to fulfill the above stated purpose. The firm's are engaged primarily in this business. They export agricultural products to foreign countries like China, Israel, Egypt, Malaysia and import oil, spare parts, paper and the like from there. There are brokers here as well as in other countries that facilitate their work. They use a payment system of letter of credit through banks. They first send their agricultural products to abroad and they in turn import goods with the money they get from the sale of their export. QAI is located around Paulos Hospital and BKIE is located on Churchill Street.

These firms faced many problems as a result of the devaluation of birr. The devaluation makes these firms not to import or export goods as much as they need since it increases their purchasing cost. The devaluation will be a blow to them because the market can not respond as usual because of inflated prices. For example, if we consider those firms which import spare parts, it is observed for a long time that their clients are turning their back to genuine parts and searching for modifies in a bid to minimize their cost. Therefore, when this devaluation effectively shows its backfire no one go there to buy parts with exaggerated prices.

When the birr depreciates and the foreign currency appreciates, the local consumer could not buy the imported goods because of weak purchasing power. The amount of their exports also

decreases as their cost increases after devaluation. This results in a decrease of their profit because their main stream of income is the sale from imported and exported goods.

These firms, due to the devaluation, are shifting recently to more of exports decreasing their imports. This is because the devaluation of birr favored exports than imports. They also faced shortage of capital since they need a large amount of birr in order to get the foreign exchange they need and can only import few products because of this capital shortage. This in turn will have its impact on the price of goods as their availability is decreasing in the market.

In general, taking the two import-export firms stated above, this study tries to answer the following basic research questions. These are

- To what extent the devaluation of birr affected these import export firms?
- Is there any performance change because of the devaluation in these import export firms?
- Will these firms decrease their import as a result of the policy's favor towards exports?
- What impact this favor has on customers of these firms?

1.3. Objectives of the Study

The general objective of the study is to see the impact of birr devaluation on the two import export firms stated earlier, QAI and BKIE. More specifically, the study is intended to

- Assess the impact of the devaluation on the performance of the two import/export firms.
- Assess how the favor of the devaluation towards exports impacts import volume of these firms.

- Assess the impact of the devaluation on their customers' purchasing activity.
- Draw some conclusions and give some comments based on the findings

1.4. Significance of the Study

Now a days birr is highly devaluating against foreign currencies. This devaluation in turn has its own impact on the performance of import/export firms and the price of goods and services. But as to my knowledge, still this issue is not clearly studied by many local researchers.

Having this in mind studying the impact of the devaluation on Ethiopian import exporters is valuable for those firms, it is significant for policy makers and it is important for all people using imported products and producing exportable items.

1.5. Scope of the Study

As a project, it is intended to get an in depth observation of impact of devaluation of birr only on two import/export firms. Therefore, the findings of this study cannot be generalized for other factors which may affect the performance of QAI and BKIE nor to situations in other import/export firms.

1.6. Definition of Basic Terms

Devaluation – is the depreciation of one currency in relation to other foreign currency. It is a decrease in value of one currency when compared to other currency.

Import – is a trade system in which a certain country purchases goods and services, which it is in short of, from another country.

Export – is a trade system in which a country sells goods and services which are excess to it to another country.

1.7. Ethical Issues

Ethics is one of the major considerations in research. The researcher of this study is also subject to the following ethical considerations.

- The research work was started after getting the willingness of the stated firms.
- Respondents were clearly communicated about the objective of the research before they are asked to give their answer.
- There was no any physical or psychological damage to them because of the research.
- To avoid language problems, the questions were asked with a commonly spoken language, Amharic.
- Respondents were not asked about their name, race, religion, etc.

1.8. Organization of the Paper

The remaining part of this paper has five chapters. Chapter two deals with the review of the related literature and chapter three contains the methodology of the study. Chapter four presents the report of the field work and chapter five is the discussion of the findings in light of the literature. Finally chapter six contains conclusions and Recommendations of the study.

CHAPTER TWO

REVIEW OF RELATED LITERATURE

2.1. Exchange Rate Regulation in Ethiopia

Ethiopia's trade policy has long been characterized by controlled foreign exchange allocation, import quotas, high tariffs, state owned marketing exports, export prohibitions, export subsidies and export taxes. For nearly half a century up until October 1992, the exchange rate of Ethiopian currency against its reference or reserve currency, the US dollar, was determined by government decree (Degefa, 2001).

The Transitional Government of Ethiopia introduced an auction system for foreign exchange in May 1993 in an effort to liberalize the foreign exchange market so as to achieve market determined exchange rate. The belief at the centre of the adoption of the auction system is to attract foreign exchange in the parallel market back to the official line and thereby strengthen official reserves.

The administrative foreign exchange allocation was also replaced by an auction system. Since May 1993, the National Bank of Ethiopia has made foreign exchange available to licensed importers through a bi-weekly auction. The frequency of the auction has increased to weekly appearance. According to the Foreign Exchange Auction Regulation, holders of valid import licenses, public industries, enterprises and organizations as well as commercial banks are eligible for the auction. The commercial banks can now engage in retail trading of foreign exchange

obtained through participation in the auction held by the National Bank. The exchange rate of the national currency against the US Dollar is thus determined by the daily auction undertaken between the commercial banks in order to encourage production for exports as well as properly manage the extent of imports. This system is considered as a transition from a fixed to a free-floating exchange rate system (Mulat and Tewodros, 2003, cited in Teshome, 2007). Elimination of the foreign exchange surrender requirement is an important aspect of exchange market liberalization. In this regard, exporters are able to sell their foreign exchange receipts to any commercial bank at freely negotiated rates over an extended conversion period of four weeks, and they can retain the remaining 10 percent in a foreign currency deposit account. Exporters are also free to use the foreign exchange remitted to the country for any imports of goods and services within the conversion period.

From May 1993 up to the unification of the official and the auction exchange rates on 25 July 1995, the exchange rate was partly determined by government decree (applicable to the official rate) and partly by quasi-market forces (applicable to the auction rate) as represented by auctions. Since the date of unification, the exchange rate of the birr against the US dollar and the resultant cross-rate has been determined only through the auction system, (Degefa, 2001).

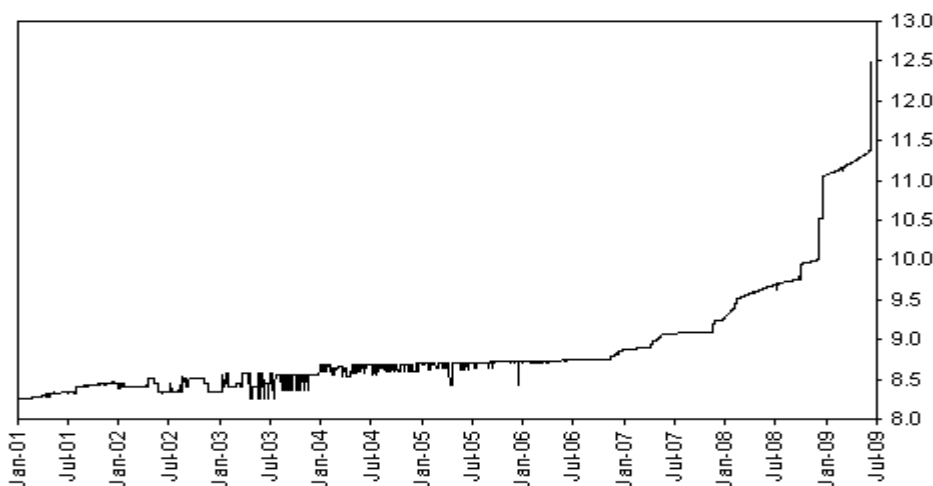
2.2. Recent History of Birr Devaluation

According to Kibret (1994, Cited in Degefa, 2001), all the relevant indicators of exchange rate misalignment, particularly the prevalence of a significant parallel premium, and the fact that the real exchange rate is consistently higher than the nominal exchange rate, suggest that the Ethiopian birr has been over-valued since the mid-1970s. By considering export weighted index, import weighted index, and trade weighted index, Kidane (1994, cited in Teshome, 2007) also

arrived at the conclusion that whether we use the nominal, real or parallel exchange rate index, and all results asserted the continuous appreciation of Ethiopian birr; the extent of appreciation, according to him, was higher during the 1980s than the 1970s. The over-valuation of the birr may be portrayed by the continuous appreciation in real official exchange rate prior to huge devaluation of the birr in October 1992 contrary to that of the parallel exchange rate.

As a consequence, birr was devaluated in 1992. The devaluation of September 1992 resulted in an exchange rate of Birr 5 for a US dollar, i.e. initially the Birr was devalued by about 142 percent. Compared to the pre-reform period the local currency (Birr) has depreciated by more than 286% in 2002. With respect to the developments in the foreign exchange market, the Birr continued to depreciate against the US dollar and stood at Birr 8.6518/USD at end June 2005. Year on year basis, the depreciation rate was 0.372 percent. Similarly, the value of the Birr in the parallel market depreciated by 0.414 percent to reach Birr 8.711/USD from Birr 8.6751/USD in the preceding year. As a result, the spread between the official and parallel market rate widened from 0.64 percent to 0.68 percent during the review year. The birr was further devalued in 2007 to 8.89 per a US Dollar (Teshome, 2007). The average value of birr against dollar in 2008 and 2009 was 9.9167 and 12.989, respectively (Website of National Bank of Ethiopia). In general, the exchange rate for the last ten years is shown on the chart below.

Chart 1 Exchange rate of birr against dollar from 2001 up to 2009



Source; National Bank of Ethiopia

2.3. Currency Devaluation and Firm Performance

When a country devalues its currency, some firms and countries generally benefit from any resulting changes in relative prices, while other firms and countries are relatively unaffected or suffer a loss in competitiveness. Immediately after devaluations, firms in the devaluing country have higher rates of output growth than competitors in other countries; immediately after devaluations, firms in that country have higher rates of operating-profit growth than competitors in other countries (Amihud Y. and Richard M, 1994).

In some previous researches, it is found that the impacts of currency depreciation are mixed among different types of firms, industries and countries. Forbes (2001) differentiates several channels by which currency depreciations affect firm performance. First, depreciation could downgrade firm competitiveness since the cost of imported inputs rises relative to foreign competitors. Second, depreciation may provide exporters with a relative cost advantage relative to foreign competitors. Third, depreciation could generate higher borrowing costs and a

contraction in lending. Forbes (2002) pioneered another strand of research by linking directly currency depreciation and firm performance. She found that firms with greater foreign sales exposure have significantly better performance after depreciations.

In contrast to the above idea, Agustinus (2005) concluded that firm performance in post devaluation period declined compared to firm performance in before devaluation period. According to him in one year after depreciation, firms have slightly positive profitability at 0.03 percent. Meanwhile, firms have negative profitability in two years after depreciation. It is predicted that firms have decrease as amount 0.8 percent of profitability due to currency depreciation in the second year according to him. It means that firms experienced negative value in two year after currency depreciation.

The extent to which firms may be hurt (or helped) by movements in the exchange rate depends in part on their ability to re-set prices in order to neutralize (or benefit from) exchange rate movements. Fabling, Joyce and Sanderson (forthcoming as cited in Agustinus, 2005) provide some initial descriptive analysis of the dispersion and evolution of export unit values across firms and over time. As unit values can be observed for detailed product classification, firm, destination and currency of invoice, it is possible to distinguish with reasonable confidence between real changes in prices and changes due to compositional differences in products and destinations. Such controls are important, since we show that firms often trade the “same” product to multiple countries at very different prices — differences that are only partially explainable by trade costs.

Agustinus found that generally firms have had lower level of profitability after currency depreciation; even in two year after depreciation most firms experienced negative profitability.

In term of market capitalization growth, firms have had also decrease values, whereas they did not have negative value. His findings show that after currency depreciation firms have higher market capitalization growth but they experience lower profitability. It is supported that the impact of devaluation on firm performance is different in two different performance measurements. Traditional exchange rate theory as well as studies using sector level data suggests real devaluations ultimately lead to expansions in the tradable sector.

Tybout, Bernard Gauthier, Giorgio Barba Navaretti and Jaime de Melo (1997) also studied firm-Level responses to the CFA devaluation in Cameroon. Using detailed survey data spanning the 1992–95 period, their study documents and interprets firms' reactions to the devaluation in terms of adjustments in output, factor usage, market orientation and productivity. They showed that the CFAF devaluation had the expected effect of increasing the return to producing tradable goods, and increased the real cost of using importing intermediate goods. Despite slow output growth, the pooled sample registered a cumulative rate of productivity growth exceeding 6% over the 1992/93 to 1994/95 period. Exporters appear to have done better than non-exporters, and medium-sized firms appear to have done the worst. These results are robust with respect to measurement technique, and can be obtained using either production or cost data. Hence encouraging signs of efficiency gains are present. The devaluation also influenced export supplies. Firms with low unit costs were relatively likely to become exporters, and tradable goods producers, who were favored by the devaluation, expanded output. However, the number of firms in their sample that exported did not increase dramatically after the devaluation.

2.4. Devaluation and Its Impact on Import/Export Firms

A variation in the exchange of a currency in relation to a foreign currency can affect the competitiveness of certain products, making them more or less expensive for foreign purchasers depending on the country devaluing or revaluing his currency. Similarly a positive or negative variation in the exchange rate can affect the price of imports of raw materials, in this way, influencing the cost price of final products. In general,

- If the local currency appreciates, it is plausible that exports would decrease as they are less competitive. Thus, if a firm manufactures above all for export, an appreciation of the local currency has a negative impact on the company sales. However, if the company imports a large part of its raw materials, it will see the price of its imports decrease. The appreciation of the local currency leads to a decrease in the takings receipts and the expenses receipts. It is necessary to determine if the impact is greater on the takings than on the expenses.
- If the local currency depreciates, local sales would increase as the manufactured products would become more competitive. All other things being equal, the price in foreign currency decreases. However, if the company imports a large part of its products, it will see its prices increase. The depreciation of the local currency leads to an increase in the takings and expenses. Again, it is necessary to determine if the impact is greater on the expenses than the takings, Alejandro (1965).

The depreciation of real exchange rate is expected to encourage exports by raising payment for exports in terms of the national currency. It is also expected to discourage imports by keeping the payments for imports higher. While exerting a positive impact on the balance payments by stimulating exports and restraining imports, devaluation also influences the cost of living, the

government budget and production. Increasing prices of essential goods such as fertilizer fuel and certain basic consumer goods consequent upon the devaluation may put extra cost on the economy.

Although learning to manage exchange rate risk is just one of a myriad of skills that new exporters need to come to grips with, exchange rate fluctuations can have substantial impacts on the incentives firms face to engage in international trade. Exchange rates affect both the cost of imported intermediate inputs, and the prices that firms receive for their export goods. For a firm that has entered into a contract to supply or purchase goods at an agreed foreign currency price, exchange rate volatility can create risk since the firm may find that its country currency value of the transaction has changed by the time payment is made. In the longer-term, real appreciation of a certain currency raises the relative price of goods for foreign consumers, inhibiting export opportunities, while long-term real depreciation raises the real cost of imported inputs, increasing production costs, Lynda Sanderson (2009).

There are also others supporting this issue. Aguiar (2002) concluded that exporting firms outperform non exporting firms in both sales and profits in the year following the devaluation which confirms the traditional prediction that the tradable sector (relatively) benefits from a real devaluation. He also argued that exporting firms posted relatively high growth rates without increasing relative capacity.

A standard argument justifying devaluations is that they should reduce the relative cost of exports on international markets and therefore improve performance of export firms. There are, however, a number of reasons why devaluations may not have this desired effect; such as if demand for exports is relatively inelastic or imported inputs are a large component of production.

Ghei and Pritchett, 1999, (cited in Agustinus, 2005) provide a detailed summary of why devaluations may or may not improve performance of exporting firms, as well as why it is difficult to measure these effects. After a review of the empirical work on this subject, they conclude that exports typically increase after devaluation, and that most of this response occurs rapidly.

Arslan (1993, cited in Agustinus, 2005), in his attempt to find out the causes of the Turkish miraculous export growth between 1980-87, found exchange rate depreciations' robust role in encouraging export firms.. However, many researchers did not find such (positive) impact of exchange rate depreciation on export. Telak & Yeok's (1998, cited in Sanderson, 2009) findings may have more relevance for the small economies whose exports are highly dependent on imported raw materials and intermediate inputs. Analyzing the case of Singapore they showed that in the presence of high import content, exports are not adversely affected by a currency appreciation because the lower import price due to appreciation reduce the cost of export production. Same result was found in Singapore by Fang.W. & Miller.S.M. (2004, cited in Sanderson, 2009) but they put the things albeit differently; they showed that in Singapore depreciation doesn't significantly improve export but exchange rate risk (generated by fluctuation) significantly impedes export firms.

Even if a country which devalues its currency is importing less, this does not signify that it is no longer important. In these countries, the cost of the imported products, notably those for raw materials, increases. Companies react to this increase in costs by increasing their prices (inflation by cost). This unpredictable effect is all the more important when the country in question is small and that it is not possible for companies to substitute national products for the imported products.

Abroad, at the same time, the price of imported components decreases. This reduction in production costs enables them to put pressure on their own prices in order to safeguard their sections of the market which are momentarily threatened by the import of competing finished products becoming cheaper in foreign currency encouraging firms engaged in export trade (Garland, 1980). Conversely, within a revaluation, entrepreneurs purchase national products at a higher price. Therefore, they see their prices increase while the country which is revaluing records a drop in production costs for its firms, and consequently can maintain stable prices. This stability of national prices ends up offsetting the advantages that have been withdrawn in the short term from the revaluation (decrease in exports) discouraging exporting firms.

CHAPTER THREE

METHODOLOGY OF THE STUDY

3.1. Research Strategy

Quantitative research design is used in situations where there are predetermined instrument based questions, performance data, attitude data, observational data. Qualitative methods are used for emerging methods, open ended questions, interview data, observation data, document data, and audio visual data. Mixed methods research on the other hand, are used for both predetermined and emerging methods, with both open ended and closed ended questions (Creswell, 2003).

As it was stated in earlier chapters, the study is undertaken on a case method by taking two import/export firms. Both qualitative and quantitative research designs (mixed methods) is used for the study. This is because performance analysis (gross profit margin on sales) is done in addition to the open ended interview questions asked to the owners of the two case companies.

3.2. Nature of Data and Method of Collection

The study used both primary and secondary data. For collecting the primary data, interview was found to be appropriate. The main sources of information are the owners of the firms and an intensive/open interview was undertaken with them. With the interview, opinions of the owners about the impact of the devaluation on their business are gathered. Secondary data was collected by analyzing documents possessed by the firms mainly their profit and loss accounts to see the impact of the devaluation on their performance. Mainly, the sales, cost of goods sold and the gross profit from sales are used for this study since these components of the income statement

are directly affected by the devaluation. Other transactions are made in the local market and cannot be directly affected by the devaluation.

3.3. Selection of Participants and Documentary Materials

It was stated previously that the subjects for the study are the two import export firms. These firms are selected for the study because the researcher personally knows the owners and hoped that the necessary information could be easily collected.

The interview was conducted on schedules which were arranged by the owners of each firm. The interview took, on average, one hour with each of the owners. The response from each of the firms was summarized in relation to the objective and research questions of the study. Even if a number of questions were asked during the interview, they are compressed in to five for analysis purpose.

In order to support the interview results, secondary data was collected from the annual financial statements of the two firms. Income statement for three years (2007 to 2009) was used to assess the impact of the devaluation on the performance of these firms.

In addition to the aforementioned sources, the researcher tried to refer different books, published and unpublished documents, journals, articles and research papers to get information on the theoretical frame work of the study.

Some difficulties were encountered in the data collection process. Among those, shortage of time for the respondents to undertake the interview and absence of organized data in the firms were the major ones.

3.4. Method of Data Analysis

The primary data collected was analyzed descriptively by summarizing the responses from the owners of the two case Companies according to the research questions and secondary data was analyzed by comparing the firms' performance before and after the devaluation. Gross profit margin on sales is used to see the impact of the devaluation on the performance of the two import/export firms.

CHAPTER FOUR

PRESENTATION OF DATA

This part of the paper presents the result of the field work. It has two main parts; the first is presentation of the primary data collected through interview and the second is the presentation of the secondary data collected from the annual financial statements of the two case companies.

The researcher took two import and export firms for the study to assess the impact of devaluation of birr on their performance. The first company, Belayneh kinde Import and Export, was established in 2005. It exports agricultural products mainly coffee and it imports many types of products such as oil, metallic products, tires, car and the like. Currently, the company has around two hundred million capital and thirty two permanent workers. The second firm, Quarit Agro Industry, is also engaged in the same line of business after being established in 2003. At this time, QAI operate its business with more than twenty employees and a total capital of around seventy two million. It purchases and sells products like stationary materials, oil, steel, plastic products, etc.

4.1. Presentation of Primary Data

The primary data was collected through an unstructured interview with the owners and the managers of the two case companies. To avoid redundancy, the questions are compressed to five considering the objectives and research questions of the study since the whole idea revolves under these main categories. The answers from both companies are presented separately as follows.

Belayneh Kinde Import and Export

Question one. What is the impact of the devaluation of birr on your business?

The respondents said that the devaluation affected them to a larger extent. They said that especially for their import, they need a large amount of birr to get a small amount of dollar. The impact of the devaluation is not only limited to imports as to the respondents. It also affects their export. After birr is depreciated, the price of commodities that are to be exported has increased highly requiring the firms a large amount of working capital to operate their business. This makes them to export a lower amount of products which in turn lowers their profit. To alleviate the problem of shortage of capital, the firms use loan from banks which has its own impact on their profit since they pay interest.

Question two. What do you think about your selling price after the devaluation of birr? Is it the same or increased?

Belayneh Kinde import and export has said that they increase their selling price, even if it may not be equivalent to the increase in the cost because of the devaluation. Since the cost of their imported items increases as the value of dollar increases, they are urged to increase their selling price transferring the effect of the devaluation towards their customers.

Question three. If you increase your selling price, what happened to your sale and profit?

They said that their sale does not decrease even if they increase their selling price. This is because there is high inflation in the country in all types of commodities. As a result, customers have no alternatives to compare. They simply purchase whatever the price is. As they stated, by transferring the effect of the devaluation to their customers, their profit is not highly affected by the devaluation of birr except that they borrowed a large amount of money with interest to avoid their capital shortage because of the devaluation.

Question four. Have you decreased the amount of your imports and increased your exports because of the devaluation?

They stated that even if exports are better after devaluation than imports, they cannot shift easily because of two main reasons. The first is that only few types of products can be exported from Ethiopia such as coffee, chat, meat, and the like. This may make them not to operate at their capacity. The second reason is that exports also are affected by the devaluation since the purchasing cost of the exportable items increase, requiring large amount of capital.

Question five. In general, should the value of birr be increased or decreased?

As to them the purchasing power of birr in relation to other foreign currencies should not be highly decreased since it brings high inflation in the market. Of course, the devaluation encourages exports to some extent but it has also its negative impact on the exports also and should be reasonable as much as possible, they said.

Quarit Agro Industry

Question one. What is the impact of the devaluation of birr on your business?

The answer obtained from Quarit Agro Industry for the first question is almost similar with that of Belayneh Kinde Import and Export. They said that the devaluation has many effects like the need of large amount of capital, decrease in profit because of an increase in the purchasing cost of both imports and exports, decrease in the reliability of customers because they think that price increases because of the devaluation, etc.

Question two. What do you think about your selling price after the devaluation of birr? Is it the same or increased?

When we see the case of Quarit Agro Industry, the response is opposite to that of Belayneh Kinde Import and Export. They said that they never increased their selling price because of the devaluation. As they stated, they finance some of their business by borrowing from banks. So that they need to quickly sell their imports to repay their loan rather than increasing their selling price and waiting until it is sold. Rather the price may increase due to other economic conditions on the country but customers may assume that as the price is increased because of the devaluation.

Question three. If you increase your selling price, what happened to your sale and profit?

As it was stated earlier, Quarit Agro Industry has not increased their selling price even if their customers may assume that price is decreasing because of the devaluation while the reason of the inflation may be another economic condition. As a result, this question was not asked to this company.

Question four. Have you decreased the amount of your imports and increased your exports because of the devaluation?

As the purchasing power of birr against dollar has decreased to a larger extent, the firm is obliged to decrease the amount of its imports even if it increased more capital to its operation. They wanted to increase their exports as they are more favored by devaluation of a certain currency. As stated earlier, devaluation has a negative impact on exports also since the purchasing cost of exportable items increase making the firm not to export in large quantity as its capital requirement increases.

Question five. In general, should the value of birr be increased or decreased?

As the major impact of the devaluation on this firm is the requirement of large amount of capital, it argued that birr should appreciate in relation to dollar. The firm said that it negatively affected both its exports and imports even if the impact is more difficult on imports and should not be devaluated.

4.2. Presentation of Secondary Data

This part is the presentation of secondary data collected from the two case companies; Belayneh Kinde import and export and Quarit Agro Industry. Profit and loss account for three years (2007_2009) was collected from both companies since birr was highly devaluated starting from 2007. Before three years, a dollar was exchanging for around 8.50 birr after that the purchasing power of the birr against dollar is continuously decreasing and now a dollar can be exchanged at around 13.75 birr as it was in shown on chart 1, page 10. Of course, to clearly see the impact of devaluation, long years of data are necessary. Due to the shortage of time, finance and available data, it is difficult at this level to take more than three years data. But the researcher believes that it can be possible to assess the impact of the devaluation on the performance of these firms to a certain extent. Of course profit performance of a firm can be affected by many factors other than devaluation that are both internal and external to it.

In order to minimize the effect of other factors, mainly gross profit of the firms is considered in the analysis. This is because gross profit is a function of sales and cost of goods sold and these two main components of an income statement are largely influenced by the exchange rate of birr against other currencies. As the birr is highly devaluated, revenue and cost of goods sold are expected to increase. Components of an income statement other than sales and cost of goods sold are not highly affected by the exchange rate of a country since they are expended or generated by

the local currency only. Cost of goods sold includes major costs such as transportation, commission of Agents abroad, insurance costs, etc. in addition to the purchase cost. In addition to the percentage changes in sales, cost of goods sold and gross profit, gross profit margin on sales is also used to assess the impact of the devaluation on the return on sales of these firms. To avoid inflation effect, the figures for 2007 and 2009 are adjusted by using inflation rates taking 2008 as a base year. The inflation rate for 2008 was 24.9% and that of 2009 was 38.7% according to CSA. Even if the two firms use Ethiopian calendar in their financial statements, it is changed in to G.C to be consistent with other parts of the paper. The data is presented as follows by comparing the figures for the three consecutive years, separately for the two case companies.

Table 1 Income statement of Belayneh Kinde import and export.

June	<u>2009 (1)</u>	<u>2008 (2)</u>	<u>2007 (3)</u>
Sales	420,877,094	90,501,102	49,516,309
Cost of Goods Sold	<u>407,343,132</u>	<u>87,066,521</u>	<u>46,911,714</u>
Gross Profit	13,533,962	3,434,581	2,604,595
Other Income-Car Rent	1,159,983	—	604,523
<u>General and administrative expenses</u>			
Salary and related benefits	191,230	56,715	42,674
Fuel and lubricants	41,785	8,694	6,731

Traveling and per diem	31,171	–	–
Stationary and supplies	32,582	3,910	2,349
Repair and maintenance	86,661	–	14,218
Telephone, internet and postage	106,622	15,115	14,216
Office rent	60,000	–	–
Water and electricity	11,603	2,555	1,472
Bank charge	271,051	290,067	304,386
Interest expense	5,387,518	1,912,162	1,741,809
Bid expense	5,284	–	11,435
Insurance	80,391	9,149	6,241
Membership fee	66,412	3,000	3,000
Commission	164,102	–	10,437
Depreciation expense	366,781	55,804	37,951
Amortization expense	12,300	–	–
Donation	35,000	–	22,000
Entertainment	25,439	–	–
Miscellaneous	447,750	–	4,365
Car rentals	541,629	8,625	13,289

Audit fee	–	4,000	4,000
	<u>7,962,311</u>	<u>2,372,835</u>	<u>2,240,573</u>
PROFIT BEFORE TAX	6,731,634	1,061,745	968,545
PROVISION FOR TAXATION	(2,376,416)	(363,661)	(338990)
TRANSFER TO BALANCE SHEET	4,355,218	698,085	629,555

Source: annual financial statement of the company.

Table 2 Adjustment for the effect of inflation: Belayneh Kinde Import and Export.

June	<u>2009 (1*0.613)</u>	<u>2008</u>	<u>2007 (3*1.249)</u>
Sale	257,997,658	90,501,102	61,845,869
Cost of goods sold	249,701,339	<u>87,066,521</u>	58,592,730
Gross profit	8,296,319	3,434,581	3,253,139
Gross profit margin on sales (GPM)	3.2%	3.8%	5.3%
GPM before adjustment	3.2%	3.8%	5.3%

Table 3 income statement for Quarit Agro Industry

June	<u>2009 (1)</u>	<u>2008 (2)</u>	<u>2007 (3)</u>
Sales	121,278,130.00	77,804,412.00	59,315,498.00

Cost of goods sold	(118,182,380.00)	(75,667,870.00)	(57,654,724.00)
Gross profit	3,095,733.00	2,136,542.00	1,660,774.00
<u>Expenses</u>			
Salary and wages	156,712.00	128,014.00	117,547.00
Commission expense	146,263.00	—	4,720.00
Rent	168,193.00	97,287.00	86,451.00
Telephone expense	52,189.00	57,151.00	39,086.00
Insurance	88,749.00	153,664.00	121,758.00
Entertainment	6,140.00	—	3,280.00
Fuel and lubricant	38,177.00	8,967.00	7,571.00
License and registration	5,100.00	850.00	—
Stationary supplies	13,411.00	6,475.00	3,469.00
Bank charges	232,080.00	183,411.00	196,893.00
Interest expense	1,483,545.00	1,138,978.00	952,482.00
Utilities	—	4,305.00	3,840.00
Depreciation	53,410.00	54,594.00	57,893.00
Repair and maintenance	7,618.00	739.00	—

Penalty	620.00	—	860.00
Miscellaneous expense	38,458.00	19,326.00	13,810.00
Audit fee	6,000.00	4,000.00	4,000.00
Weight loss	113,731.00	46,000.00	29,347.00
	<u>2,610,396.00</u>	<u>1,903,761.00</u>	<u>1,643,034.00</u>
Profit (loss) for the year	485,337.00	232,781.00	182,260.00
Provision for taxation	<u>147,629.00</u>	<u>69,834.30</u>	<u>54,678.00</u>
	337,708.00	162,946.70	127,582.00
Transferred to legal reserve	<u>16,885.00</u>	<u>8,147.34</u>	<u>6,379.00</u>
	<u>320,823.00</u>	<u>154,799.36</u>	<u>121,202.00</u>

Source: annual financial statement of the company.

Table 4 Adjustment for the effect of inflation, Quarit Agro Industry

June	<u>2009 (1*0.613)</u>	<u>2008</u>	<u>2007 (3*1.249)</u>
Sale	74,343,493	77,804,412	74,085,057
Cost of goods sold	72,445,798	<u>75,667,870</u>	72,010,750
Gross profit	1,897,695	2,136,542	2,074,307
Gross profit margin on sales	2.6%	2.7%	2.8%

GPM before adjustment	2.6%	2.7%	2.8%
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CHAPTER FIVE

DISCUSSION

5.1. Discussion of Primary Data

In this part the data presented in chapter four is analyzed and discussed in relation with the theoretical literature in chapter two. Based on this analysis some conclusions are drawn and recommendations are forwarded in certain issues.

When a country devalues its currency, some firms and countries generally benefit from any resulting changes in relative prices, while other firms and countries are relatively unaffected or suffer a loss in competitiveness, Forbes (2002). Among others firms engaged in import and export are those which can be affected with currency devaluation to a larger extent. The two case companies were asked to express their view about the impact that the devaluation of birr has on their operation. Even if it is believed in the theory that exports are more favored by devaluation than imports, it is not the case when we see it from the aspect of firm level. It has a negative impact both on imports and exports as their purchasing cost increases and the firms are required to have a large amount of capital or they are urged to decrease the amount of their imports and exports. As a result of the requirement of large amount of capital, firms will go for a loan which has its own impact on their profitability. The case is more serious for the import side as their profit decreases since their selling price can not be increased as the increase in their purchasing cost because of the devaluation of birr.

The second question was related to the pricing policy of the firms after birr was highly devaluated by the government. In a country which highly dependent on imported goods, devaluation has a great impact on the pricing policy of firms engaged in import and export. When the currency of a certain country is highly devaluated, the price of both imports and exports will increase if there are no many substitute local goods in the country, Dholakia and Raveendrasa (2000). Belayneh Kinde import and export increase its selling price even if the increase may not be equivalent with the increase in their cost after birr is devaluated where as Quarit Agro Industry do not increase its selling price because of the devaluation. As it was stated earlier, the firms finance some part of their operation by borrowing from banks. They need to resell their inventory quickly so that they can repay their loan instead of increasing their price and waiting until it is sold.

Firms were also asked whether they decreased their imports and shifted to exports because of the devaluation of birr. In the longer-term, real appreciation of a certain currency raises the relative price of goods for foreign consumers, inhibiting export opportunities, while long-term real depreciation raises the real cost of imported products, Lynda Sanderson (2009). There are also others supporting this issue. Aguiar (2002) concluded that exporting firms outperform non exporting firms in both sales and profits in the year following the devaluation which confirms the traditional prediction that the tradable sector (relatively) benefits from a real devaluation. He also argued that exporting firms posted relatively high growth rates without increasing relative capacity. When we come to the case of these two companies, they couldn't shift easily from imports to exports. This is because there are no much tradable goods in Ethiopia as only few types of agricultural products can be exported and the cost of exports is also higher after the devaluation.

5.2. Discussion of Secondary Data

The secondary data obtained from the three years income statement of the two case companies is analyzed by comparing the year to year trend. The year 2008 is used as a base year and the figures for 2007 and 2009 are adjusted based on the respective inflation rates obtained from the Central Statistics Agency of Ethiopia.

It is known in the literature that devaluation of a certain currency affects performance of a firm especially those which are engaged in foreign trade as their work depends not only on their country's currency but also with the relative value of that currency to other currencies. Agustinus (2005) concluded that firm performance in post devaluation period declined compared to firm performance in before devaluation period. According to him in one year after depreciation, firms have slightly positive profitability at 0.03 percent. Meanwhile, firms have negative profitability in two years after depreciation. It is predicted that firms have decrease as amount 0.8 percent of profitability due to currency depreciation in the second year according to him. It means that firms experienced negative value in two year after currency depreciation. Forbes (2002) also founded that firms with greater foreign sales exposure have significantly better performance after depreciations.

The impact of devaluation of birr on the profitability of the case firms was assessed on the basis of gross profit margin on sale. Both revenue and cost of goods sold for Belayneh Kinde Import and Export increase markedly from the years 2007 to 2008. Gross profit decreased from 2007 to 2008 but increased from 2008 to 2009. When we see the change in terms of percentage value, sales has increased by 46.3% from 2007 to 2008 and cost of goods sold has increased by 48.6%.

As a result, gross profit has increased by 5.6% and gross profit margin on sales has decreased to 3.8% from 5.3%. Even if the figure for sales, cost of goods sold and gross profit on sales have shown an increase from 2007 to 2008, the case is different for gross profit margin on sale as it shows a decrease from 5.3% to 3.8%. As it was stated in the presentation of the primary data, the firm can not increase its selling price at the same rate as the increase in the purchasing cost because of the devaluation of birr. This makes their revenue not to increase in the same percent as their cost and margin on sales to decrease, (See table 2 on page 27).

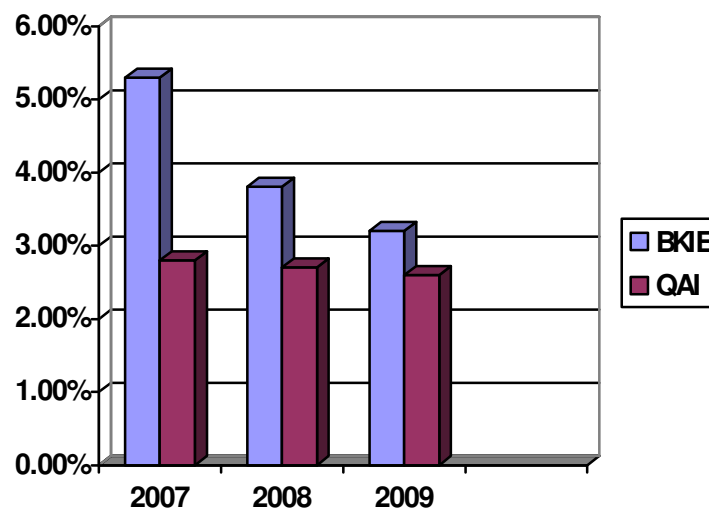
From 2008 to 2009, both revenue and cost of goods sold increased at a larger rate, 185% and 187%, respectively, making gross profit to increase by 142% but gross profit margin on sales decreased from 3.8% to 3.2%. The firm increased its sales and gross profit by adding more capital to the business in order to avoid the shortage of the capital because of the devaluation of birr. Even if gross profit has increased from 2007 to 2009, the figures for gross profit margin on sales are decreasing. Keeping other things constant, the profitability of Belayneh Kinde Import and Export has decreased over the years.

Quarit Agro Industry's sales, cost of goods sold and its gross profit (shown on table 4, page 30) are increasing from 2007 to 2008. It is shown that revenue increased by 5% from 2007 to 2008. Cost of goods sold has also increased by 5.1% from 2007 to 2008. As a result, Gross profit has increased by 3% from 2007 to 2008. Gross profit margin on sales on the other hand decreased from 2.8% in 2007 to 2.7% in 2008.

When we compare the figures of 2008 with that of 2009, the trend is different from that observed earlier. All the figures for revenue, cost of goods sold, and gross profit have decreased from 2008 to 2009. Sales, cost of goods sold, and gross profit have decreased by 4.4%, 4.3% and 1.1%,

respectively, from 2008 to 2009. It is observed that the profitability of Quarit Agro industry is also decreasing after birr is devaluated as its gross profit margin on sales shows a decrease from 2.8% in 2007 to 2.6% in 2009. As it was stated in the first part of the analysis, Quarit Agro Industry said that there is a capital shortage because of the devaluation of birr and it does not increase its selling price even if the purchasing cost is increasing. These two major reasons made the firm's sale, cost of goods sold and gross profit to decrease after birr is highly devaluated keeping other factors constant. The gross profit margin on sales of the two firms from the years 2007 to 2009 is summarized on the chart below.

Chart 2. Gross profit margin for the two firms from 2007 to 2009



CHAPTER SIX

CONCLUSION AND RECOMMENDATION

6.1. Conclusion

After a detail analysis of both the primary and secondary data collected, the following major conclusions are drawn.

- Devaluation of birr has affected the import and export firms in many aspects such as decrease in the reliability of customers, requirement of large amount of capital since they need much amount of birr to get a small amount of dollar, etc.
- The firms have not decreased their imports and transferred to exports because of two major reasons. One is the availability of only few types of agricultural products that can be exported from Ethiopia and the second is that exports are also affected since the purchasing cost for exportable items increases after birr is devaluated.
- The devaluation did not bring a great change on the pricing policy of the firms. Belayneh Kinde Import and Export adjusts its selling price after birr is devaluated while Quarit Agro Industry did not change its selling price even if customers may assume that price is changed because of the devaluation while the inflation is the result of other economic factors.
- After birr is highly devaluated, the profitability of these firms has decreased keeping other factors constant. The gross profit margin on sales has decreased from 2007 to 2009.

6.2. Recommendation

Based on the analysis, discussion and the findings of the study, the following recommendations are given that may help the firms under consideration to use the opportunities and handle the challenges of devaluation of birr. These are

- ❖ The firms should design some strategies that can help them offset the decrease in profit like efficient utilization of resources, decrease in wastage, increase more capital to their business, etc.
- ❖ Firms may also use strategies that can minimize exchange rate risk such as currency forward agreements, currency futures contracts, currency options contracts, currency swaps, etc.
- ❖ In order to minimize the decrease in the reliability of customers, the firms must clearly communicate with them about the devaluation, its impact on their cost and pricing policy, etc.
- ❖ The firms should try to increase their exports. Even if there are only few products that can be sold from Ethiopia, they should increase their sale by exporting more agricultural products which are exportable.

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Appendices

Interview Questions

1. What is the impact of the devaluation of birr on your business?
2. What do you think about your selling price after the devaluation of birr? Is it the same or increased?
3. If you increase your selling price, what happened to your sale and profit?
4. Have you decreased the amount of your imports and increased your exports because of the devaluation?
5. In general, should the value of birr be increased or decreased?

Declaration

The project is my original work, has not been presented for a degree in any other University and that all sources of material used for the project have been duly acknowledged.

Tewabe Gashaw
