

**The Federal Democratic Republic of Ethiopia: 2007 Article IV Consultation—Staff Report; Staff Supplement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for the Federal Democratic Republic of Ethiopia**

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2007 Article IV consultation with The Federal Democratic Republic of Ethiopia, the following documents have been released and are included in this package.

- The staff report for the 2007 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on March 9, 2007, with the officials of The Federal Democratic Republic of Ethiopia on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on May 18, 2007. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- A staff supplement on the joint IMF/World Bank debt sustainability analysis.
- A Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its June 1, 2007 discussion of the staff report that concluded the Article IV consultation.
- A statement by the Executive Director for The Federal Democratic Republic of Ethiopia.

The document listed below has been or will be separately released.

Statistical Appendix

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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INTERNATIONAL MONETARY FUND

THE FEDERAL DEMOCRATIC REPUBLIC OF ETHIOPIA

**Staff Report for the 2007 Article IV Consultation**

Prepared by the Staff Representatives for the 2007 Consultation with  
The Federal Democratic Republic of Ethiopia

Approved by Siddharth Tiwari and Carlo Cottarelli

May 18, 2007

- **Last Article IV consultation.** The 2005 Article IV consultation pointed out the pressure building on Ethiopia's balance of payments from persistently high world oil prices and increases in public sector investment. Executive Directors cautioned that scaling up domestically financed investments jeopardized macroeconomic stability. They therefore welcomed the expenditure cuts that were introduced and the authorities' commitment to take additional measures to protect international reserves. Directors also noted that a tighter fiscal and monetary stance might be required to contain demand and to stabilize the balance of payments. The Ethiopian authorities have been broadly responsive to Fund advice, albeit with delay in some instances and somewhat tepid intensity.
- **Backdrop of mission.** Uncertainty regarding donor assistance remains high. Because of concerns about political governance, donors had suspended their budget support when unrest erupted after the May 2005 elections. However, support has recently been increasing through the Protection of Basic Services operation (supported by the World Bank and other donors). In December 2006, the Ethiopian government dispatched its troops to Somalia to support the Somali transitional government. Though this action initially raised additional concerns, no major economic impact has so far been reported.
- **Exchange rate.** The authorities describe their de jure exchange rate regime as a managed float with no predetermined path for the exchange rate. However, in light of the relative stability in the rate as well as the authorities' intervention policy, the exchange rate regime has de facto been akin to a conventional peg, although recently exchange rate flexibility has increased somewhat.
- **Participants.** Discussions were held February 23–March 9, 2007. The mission met with Prime Minister Meles Zenawi, Minister of Finance and Economic Development Sufian Ahmed, Central Bank Governor Teklewold Atnafu, senior officials, and representatives of civil society and the donor community. The mission team consisted of Messrs. Itam, Doré, and Honda, Ms. Lu (all AFR), and Mr. Thomas (PDR). Mr. Peraza (STA) joined the mission to work with the officials on the Statistical Appendix and Ms. Majaha-Jartby (MCM) joined it to help enhance financial surveillance. Mr. Schwidrowski (Senior Resident Representative) assisted the mission. Messrs. Kamara and Kanu (OED) attended most of the meetings. Messrs. Kato and Gerson (OMD) participated in the final round. The mission collaborated with the World Bank Resident Mission in Addis Ababa and was joined by a staff member from the African Development Bank (AfDB).

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## EXECUTIVE SUMMARY

**Focus of the report:** The discussions for the 2007 Article IV consultation focused on the policy requirement for (i) addressing current macroeconomic imbalances (rising inflation and low official international reserves); and (ii) preserving medium-term macroeconomic stability while fostering growth potential.

**Background:** The economy has been enjoying a buoyant expansion since the drought-related contraction in 2002/03.<sup>1</sup> Real GDP rebounded to an annual average growth rate of 10.7 percent for 2003/04 through 2005/06—significantly above the average of 5.8 percent for sub-Saharan Africa. Although agriculture continues to be the mainstay of the economy, the recent expansion has been broad-based, with manufacturing, construction, and services making significant contributions. However, inflation has accelerated. It reached 19 percent in February 2007. Official international reserves have fallen below 2 months of import coverage. Expansion of domestic credit has continued to be brisk, reflecting a pick-up in private sector economic activity and increasingly negative real interest rates.

**Challenges:** While the economic outlook seems favorable with strong macro policy implementation, there are significant risks. There is very little margin for policy slippages if economic stability is to be maintained, adverse weather may recur, structural bottlenecks and constraints persist, and the environment is not yet fully conducive to private sector-led growth. A critical challenge for Ethiopia is to strike a judicious balance between demand-dampening measures and growth-enhancing structural reforms.

**The authorities' views:** The authorities give macroeconomic stability a high priority, though they reiterate the need to maintain the current growth momentum. They shared staff concerns about inflation and low official international reserves and recognized the adverse impact they have, particularly on the urban poor and on business confidence, while the authorities favor a more gradual approach in some policy areas (in terms of monetary tightening and exchange rate flexibility) than the staff.

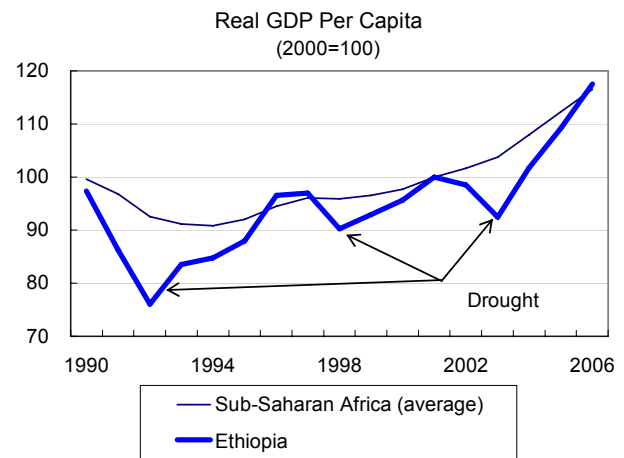
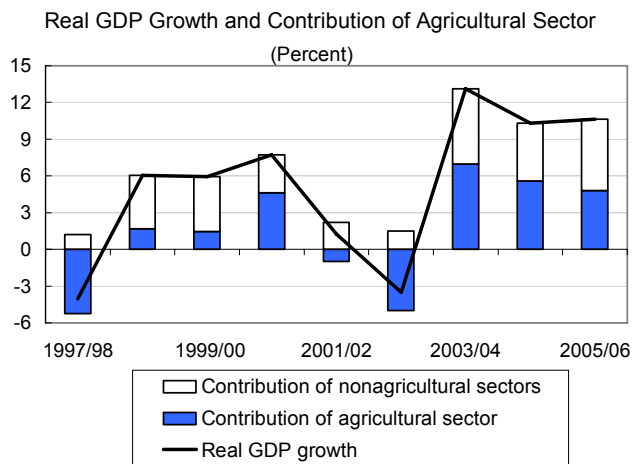
**Staff views:** Staff encouraged the authorities to make forceful fiscal adjustments (some new revenue measures and cuts in nonpriority expenditures) and support them with a tighter monetary policy and greater exchange rate flexibility to ease demand pressures and start to push inflation downward. They also stressed the importance of addressing emerging supply constraints and the limited implementation and absorptive capacities of the economy, and of establishing a sound, dynamic, and competitive financial sector.

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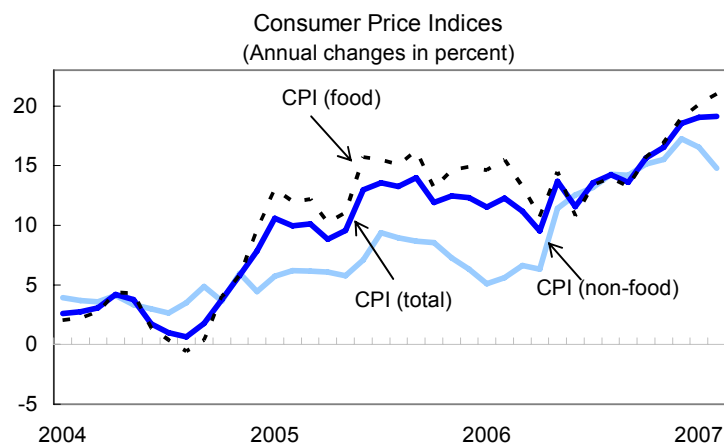
<sup>1</sup> The fiscal year runs from July 8 to July 7.

## I. RECENT DEVELOPMENTS

1. **The economy has enjoyed strong and steady growth for the past three years (Table 1).** After a significant drought-related contraction in 2002/03, it rebounded with an annual average growth rate of 10.7 percent for 2003/04–2005/06—significantly above the average of 5.8 percent realized in sub-Saharan Africa. As a result, real per capita income increased at an annual average of 7 percent—the fastest rate in Ethiopia’s recent history. Although agriculture continued to be dominant, the expansion has been broad-based, with significant contributions from manufacturing, construction, and services.

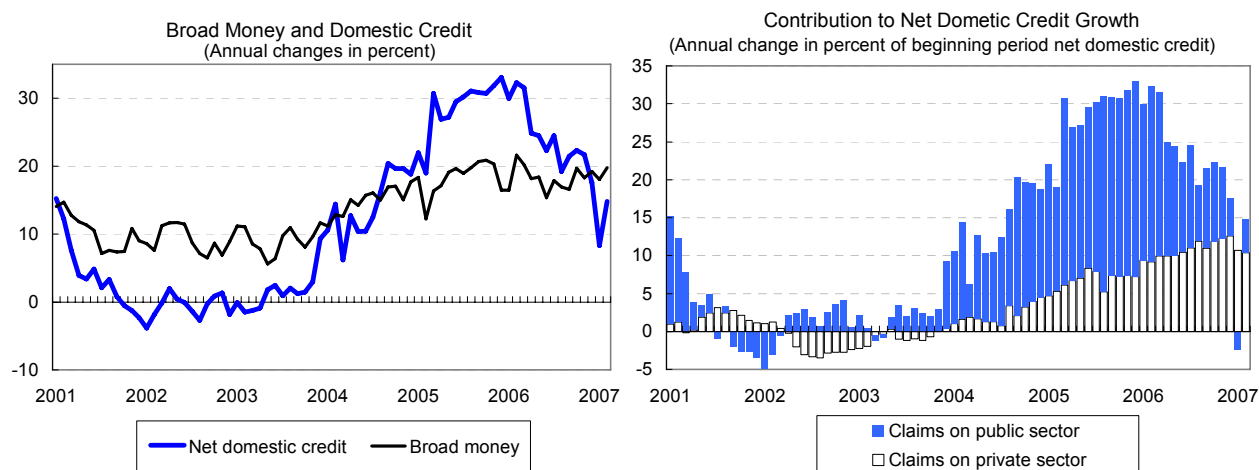


2. **Unfortunately, as growth rebounded, inflation rose.** While inflation was less than 10 percent for most of 2003/04–2004/05, it accelerated in mid-2005 and reached 18.5 percent at the end of 2006. The surge in food prices reflected higher disposable income and some supply-side factors: (i) farmers were able to supply agricultural produce more uniformly over the year (after improvements in access to credit, storage facilities, marketing information, and incomes), which helped avoid excess supply during harvesting seasons; and (ii) the total supply of cereals fell after some donors switched from food to cash aid. Nonfood inflation was also high, 17.3 percent at the end of 2006, because of the continued strong demand associated with large-scale public investment, rapid expansion of domestic credit, and upward adjustments in controlled fuel prices in May and August 2006.

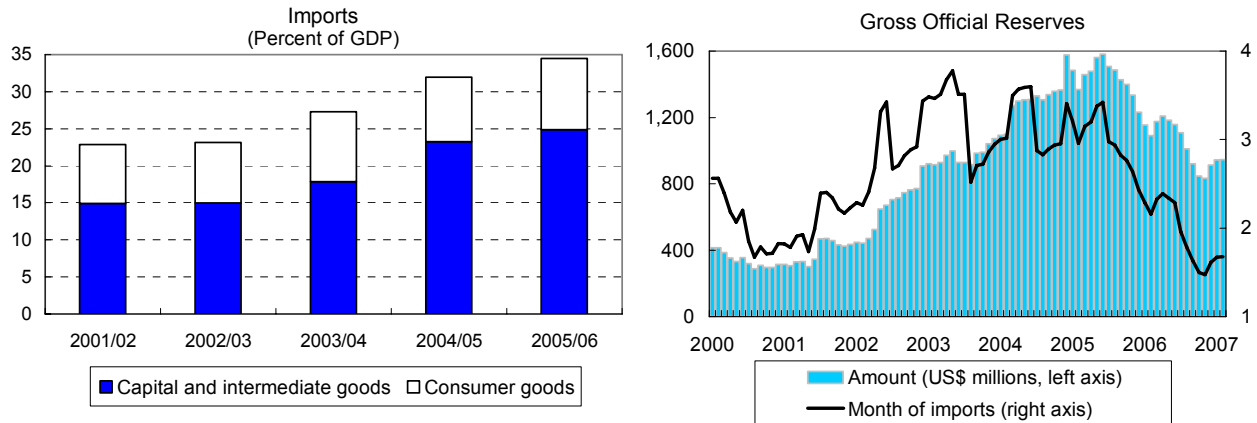


3. **Public finances deteriorated in 2004/05–2005/06 (Tables 2 and 3).** After declining to 0.2 percent of GDP in 2003/04, net domestic borrowing to finance the budget rose to 3.1 percent of GDP in 2005/06 as the domestic revenue effort declined and donors significantly reduced budget support (a shortfall of 2 percentage points of GDP from what was budgeted). Consequently, though expenditures were scaled down from the original budget by postponing large-scale infrastructure projects and constraining recurrent outlays, the overall budget deficit (including grants) was large, about 4½ percent of GDP a year for 2004/05–2005/06.

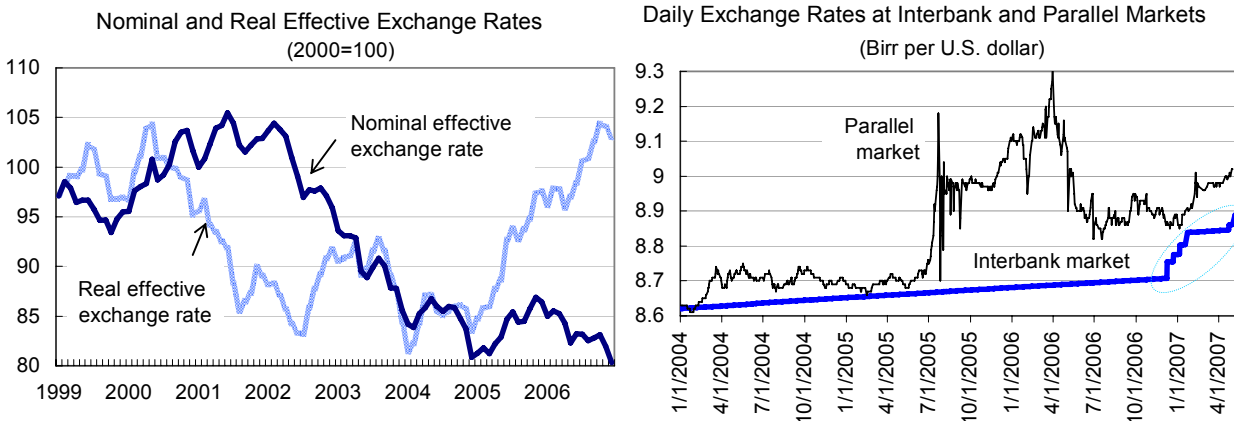
4. **Monetary conditions were accommodative (Table 4).** Broad money grew relatively fast in 2005 and 2006, mainly driven by credit expansion to both government and nongovernment sectors. Demand for bank credit rose sharply to finance large-scale investment projects by public enterprises and the rapidly expanding private sector. To some extent, private demand for credit was spurred by the substantial negative real interest rates. With nominal lending rates averaging 8.6 percent, loan demand—especially for housing construction and consumer durables—shot up. At the same time, the excess reserves of commercial banks, which are not remunerated, also fueled the rapid expansion of credit.



5. **With rising domestic demand, particularly for imported raw material and capital goods, the external current account deficit (after official grants) widened to 10½ percent of GDP in 2005/06.** Although there was steady growth in exports of goods, mainly agricultural products, and services, imports rose even faster. Even though the capital account surplus (including substantial errors and omissions suspected to be unrecorded inward remittances) nearly doubled, the overall balance of payments moved from a significant surplus in 2003/04 to a cumulative deficit equivalent to 2 percent of GDP for 2004/05–2005/06, a result in part of the shortfall in donor budget support. Gross official international reserves therefore declined from the equivalent of 3.7 months of imports at the end of 2003/04 to 2.1 months of imports at the end of 2005/06.



6. **The official exchange rate for the Birr against the U.S. dollar (the intervention currency) was relatively stable despite the widening external imbalances;** it stood at Birr 8.78 to the dollar at the end of 2006. The parallel market rate moved within a narrow range.<sup>2</sup> With domestic prices rising rapidly, the real effective exchange rate appreciated by 6 percent in 2006. However, because export prices are fixed in foreign currency and relative price shifts take time to influence supply, the appreciation may have only moderated the export growth in recent years though there has been some substitution of imports for domestic goods.



7. **The economy continues to grow relatively fast, with a little easing of pressures on international reserves.** Real GDP growth in 2006/07 is projected to hold at about 9½ percent as productivity gains in agriculture continue and nonagriculture activities, especially manufacturing and construction, expand further. Domestic demand has been solid, given

<sup>2</sup> The NBE and commercial banks (with exporters/importers as customers) are the only market players in the inter-bank market, while foreign exchange dealers, and other exporters/importers participate in the parallel market that has been in existence (with official knowledge and monitoring) for several years.



major investments in infrastructure and growing private consumption. Inflation is projected to decline only to about 15 percent at the end of 2006/07, despite the completion of the pass-through of fuel price increases and full adoption by farmers of the new pattern for food supply. After a period of relative stability, the depreciation of the birr against the U.S. dollar has in recent months become more pronounced.

8. **The fiscal stance in 2006/07 is now expected to be tighter than originally envisaged.** The authorities had originally planned for a net domestic borrowing of about 4 percent of GDP but the final budget reduced the amount to less than 3 percent. To help contain pressures on prices and the external position, the authorities are reducing recurrent expenditures, particularly those not affecting the poor, stretching out large capital outlays, and have introduced import surcharges to raise revenues. As a result, the overall deficit is projected at 4.3 percent of GDP, and net domestic financing of the budget would be limited to 2½ percent of GDP, which the staff believe to be feasible

	2003/04		2004/05		2005/06		2006/07	
	Actual	Actual	Budget	Actual	Budget	Staff proj.		
Revenue and grant	21.9	20.5	25.1	21.0	23.5	23.3		
Revenue	17.0	15.8	18.9	16.9	17.5	17.3		
Tax revenue	13.3	12.6	13.4	12.2	12.6	12.5		
Non-tax revenue	3.7	3.2	5.5	4.6	4.8	4.8		
Grant (excluding MDRI)	4.9	4.6	6.3	4.1	6.0	6.0		
Expenditure	25.1	25.2	30.4	25.4	28.5	27.6		
Current expenditure	14.6	13.4	14.0	13.2	13.1	12.6		
Poverty-targeted expenditure <sup>1</sup>	4.9	5.0	5.4	5.6	5.2	5.2		
Other	9.7	8.4	8.6	7.6	7.9	7.4		
Capital expenditure <sup>2</sup>	10.5	11.8	16.4	12.2	15.4	14.9		
Fiscal balance (including grant)	-3.2	-4.7	-5.2	-4.4	-5.0	-4.3		
Total financing	3.2	4.7	5.2	4.4	5.0	4.3		
External financing	2.9	2.4	1.8	1.3	2.3	1.7		
Domestic financing (excluding MDRI)	0.2	2.3	3.5	3.1	2.7	2.5		
Other/Residual	-2.4	-1.3	0.0	1.6	0.0	0.0		

Source: MoFED

<sup>1</sup> Expenditures related to education, health, agriculture, and roads.

<sup>2</sup> Including expenditures under special program.

9. **The external position is expected to strengthen somewhat in 2006/07 (Table 5).** Export growth, led by coffee and horticulture, is projected to combine with substantial increases in official transfers as relations with donors normalize, reducing the current account deficit by about half, to 5.6 percent of GDP. The overall balance of payments is projected to register a surplus of 2.1 percent of GDP, raising gross official international reserves to the equivalent of 2.2 months of imports by the end of 2006/07.

## II. POLICIES TO ADDRESS MACROECONOMIC IMBALANCES

10. **Despite strong growth in recent years, there are significant concerns about inflation and low international reserves.** Inflation has risen virtually continuously since early 2006, hitting 19 percent in February 2007 (the latest data available). At the same time, official reserves have been declining, mainly because disbursements of external assistance have been delayed. The authorities concurred with the staff that the impact of inflation, particularly on the urban poor, is very heavy and efforts should be made to bring it down. Their main objective is to consolidate macroeconomic stability while maintaining growth momentum over the medium term; the intention is to reduce inflation to single digits and build international reserves to 10–12 weeks of import coverage. However, the authorities argued that the factors contributing to the high inflation should be studied further before taking additional policy actions. The staff cautioned that action was needed promptly to prevent expectations of high inflation from becoming entrenched. In particular, the staff stressed that remedial actions to address macroeconomic imbalances should be based on prudent fiscal and monetary policies and a more flexible exchange rate.

11. **Fiscal policy should help contain pressures on prices and international reserves and crowd in the private sector.** There was agreement that fiscal policy should be anchored in net domestic borrowing by the government. The authorities concurred with staff that the appropriate level over the medium term should be 2–2½ percent in order to (i) release resources to the private sector over the medium term, while ensuring a gradual decline in overall money growth to help contain inflation pressures, (ii) contain demand pressures and mitigate impacts on the external position, and (iii) gradually reduce domestic debt, providing the flexibility to respond to shocks, particularly climatic shocks that may call for additional expenditures. To achieve these targets, nonessential recurrent outlays should be further streamlined, with adequate provision for operations and maintenance. Selection criteria for capital projects should emphasize productivity and contribution to growth; noncritical projects with high import content should be avoided. In this context, the authorities noted that expenditures (particularly on capital goods) would be reduced in case of a shortfall in revenue collection. Efforts to mobilize more domestic revenue should complement the expenditure measures. The yield from the new surcharge on imports and other measures under consideration should raise tax revenue from just under 17 percent of GDP in 2005/06 to about 18 percent a year over the medium term, which would be roughly comparable to other countries in the region.<sup>3</sup> Nevertheless, vigilance is necessary to prevent the erosion in tax revenue that occurred in the last two years.

12. **Monetary policy should be directed to achieving the inflation and international reserves targets, but this will require more effective instruments.** Currently, the authorities rely on direct instruments, such as ceilings on domestic credit to the government. The efficacy of indirect instruments like open market operations with treasury bills has been

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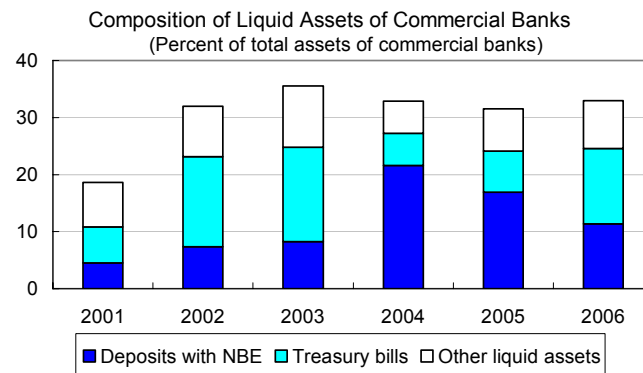
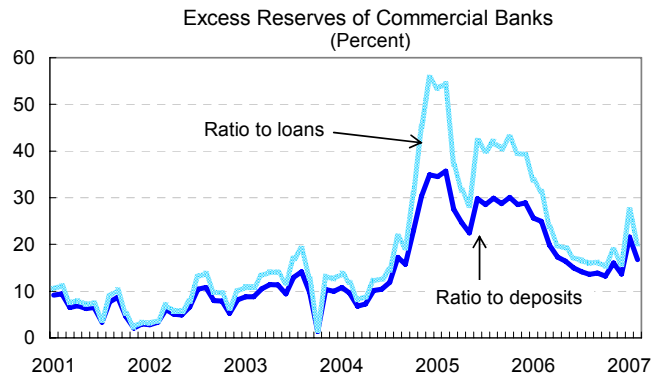
<sup>3</sup> Effective April 11, 2007, a surtax (10 percent of CIF value) was imposed on some imported consumer goods (excluding items for basic needs).

### Box 1. Ethiopia: Excess Reserves in Commercial Banks

As of December 2006, bank reserves exceeded the required level (5 percent of deposits) by about 14 percentage points. The state-owned Commercial Bank of Ethiopia (CBE) holds a disproportionately large amount. Reserves rose sharply in mid-2004, while the overall liquid assets of commercial banks were kept almost constant during 2002–2006. This reflected the shift from issuing treasury bills to central bank financing in 2004/05.

The excess reserves have led to artificially low rates at treasury bill auctions; and precluded the effective use of indirect monetary policy, while enabling banks to expand credit rapidly.

The only attempt to reduce excess reserves has been the issuance of short-term treasury bills. This did help reduce excess reserves from 29 percent of deposits at the end of 2005 to 14 percent a year later. However, reserves are still high compared to other countries in the region, and the effect of the issuance of short-term treasury bills on the credit expansion would be limited until the excess reserves have been lowered to a reasonable level.



	Reserve Requirement Ratio		Excess reserves (Percent of deposits)	
	2005	2006	2005	2006
Ethiopia	5	5	28.9	13.7
Kenya	6	6	0.3	0.6
Tanzania	10	10	2.0	1.0
Uganda	10	10	1.8	-0.4

diluted significantly because of structural rigidities, such as the substantial excess cash reserves of commercial banks (see box 1). There was agreement on the need to rely more on indirect instruments for monetary policy in the medium term; staff recommended reinforcing the recent effort to mop up excess cash reserves through the sale of longer-term securities, facilitating the interbank market (to better allocate the resources to banks in need), and promoting a more efficient and competitive financial sector. The staff also argued that a gradual move to positive real interest rates, starting with a sizeable upfront increase in the minimum deposit rate above the current 3 percent, in combination with the effort to reduce excess reserves, is needed to contain inflationary pressures.

13. **Continued depletion of international reserves in recent months has prompted the monetary authorities to take measures to defend the level of official reserves.** They have issued directives promoting inward remittances and foreign currency deposits, and are enforcing the surrender requirement for receipts from tourists and exports of flowers. Exporters have been given easier access to domestic financing. The staff argued that a more enduring measure would be to allow the exchange rate—which appears to be overvalued—to adjust more rapidly, noting the cumulative real appreciation of about 20 percent since early 2005 (see box 2). This should be supplemented with restraints to moderate import demand by the public sector, including rephasing large infrastructure projects.

14. **The authorities describe the de jure exchange rate regime in Ethiopia as a managed float with no predetermined path for the exchange rate.** The interventions of NBE in the foreign exchange market have been used primarily to supply foreign exchange in virtually fixed amounts at regular intervals. Nevertheless, the staff observed that the Birr has been relatively stable against the U.S. dollar, and that the NBE supplies foreign exchange to the market based on plans established at the beginning of each fiscal year that take into account estimates of likely supply and demand. These plans—in particular the exchange rate path—are not modified when demand or supply conditions change, which means the de facto exchange rate regime has been until recently akin to a conventional peg. However, in the last few months, the exchange rate has been appropriately allowed to depreciate somewhat faster.

15. **The authorities agreed that the relatively stable nominal exchange rate may not enhance growth over the medium term, and noted that the real appreciation in recent years should be reversed in an orderly and gradual manner.** In this regard, the staff is of the view that the immediate priority is to allow the exchange rate to depreciate more rapidly within the context of the de jure regime of a managed float. In the circumstances of the economy—with severe deficiencies in data that impede a precise calculation of the long-term equilibrium exchange rate, and needing substantial structural reforms for a more competitive environment—this regime may be appropriate to reflect the evolving fundamental conditions.

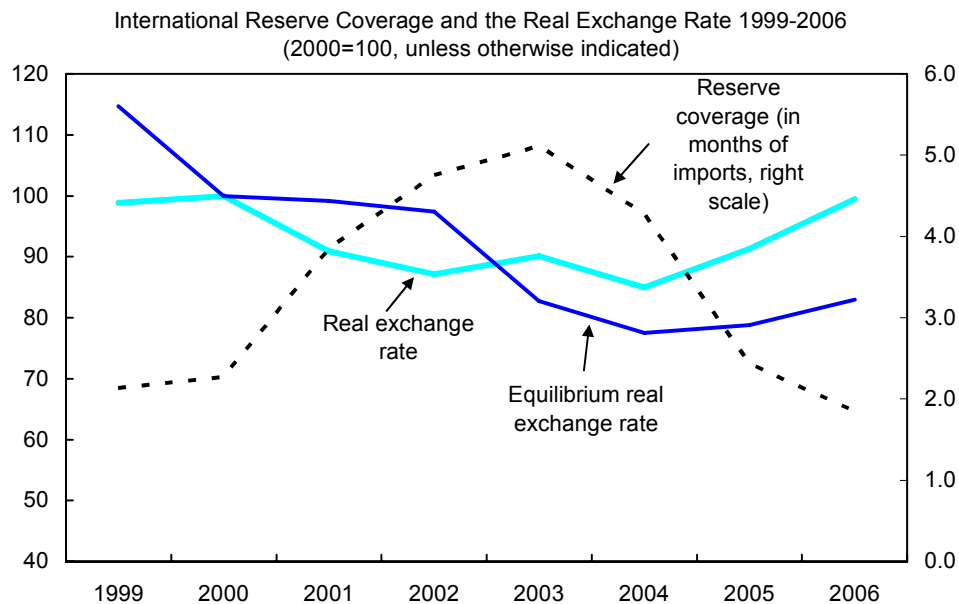
16. **The authorities reiterated their policy of relying on grants and concessional loans (consistent with international terms for concessionality) to finance development.** Recognizing the risks of an unsustainable debt burden, they stressed their commitment to use wisely the fiscal space provided by recent debt relief (HIPC, MDRI, and bilateral), guided by the IMF/World Bank Debt Sustainability framework. This approach will apply to both traditional and nontraditional lenders. In particular, they will exercise great caution in contracting or guaranteeing new loans.

### Box 2. Ethiopia: Exchange Rate Assessment

Various assessments suggest that the real exchange rate is overvalued, although the magnitude of the misalignment varies. The current account deficit (net of current transfers) at over 10 percent of GDP in 2005/06 was at its highest level for over a decade, and the net present value (NPV) of external debt in relation to exports is projected to double over the next decade. Moreover, the international reserves coverage (measured in terms of months of imports) is at the lowest level in several years.

Also, recent econometric estimates suggest that the real exchange rate has risen considerably above its equilibrium level. Gilmour and Chudik (2007) argued that the real exchange rate in Ethiopia is cointegrated with the terms of trade, openness (measured as the ratio of imports and exports to GDP), productivity relative to its major trading partners, and government consumption in relation to GDP. Since 2003, when the real exchange rate was estimated to be in equilibrium, the real exchange rate has appreciated considerably reflecting a growing disparity between Ethiopian and trading partner inflation rates. Moreover, the equilibrium exchange rate has depreciated with upward pressure on the equilibrium REER from better terms of trade and increased government consumption more than offset by downward pressure on the real exchange rate from increased openness. As a result, based on this approach, the real exchange rate would be currently about 25 percent above its equilibrium value.

On the other hand, the level of the real effective exchange rate in 2006 was only about 5 percentage points above the average over the previous ten years. Similarly, the parallel market premium, which averaged some 3½ percentage points during mid-2005–late 2006, is currently only about 1½ percentage points.



### III. ENHANCING GROWTH

17. **The authorities affirmed their objective of achieving the Millennium Development Goals (MDGs)<sup>4</sup> through Ethiopia's Program for Accelerated and**

<sup>4</sup> Progress in achieving the MDGs is summarized in Table 6.

**Sustainable Development to End Poverty (PASDEP).**<sup>5</sup> They are aiming at a minimum average annual growth rate of 7 percent over the medium term, stating that, given recent growth performance, even 10 percent was within reach. The strategy to achieve growth centers on boosting economic activity by commercializing agriculture and fostering the nonfarm private sector. The authorities emphasized that their policies must concentrate on removing obstacles to growth, stimulating private sector development (with special attention to the investment climate), and building the financial sector.

18. **In the discussions there was a general consensus on the main obstacles to growth.** Macroeconomic stability and debt sustainability were recognized as prerequisites for strong, sustainable growth, but progress will be limited unless the emerging supply constraints are addressed expeditiously and implementation and absorptive capacities are expanded. Staff pointed to the recent shortage of cement and semiskilled labor as indications of supply constraints that could only be relaxed with continued structural reforms and with training. Other constraints identified are (i) land access (i.e., the availability of land, variations in leasing regulations between regions, pricing of land-use rights, and inability to use land as collateral); (ii) limited access to financing (mainly long-term), in part caused by the limited capacity of domestic banks and the paucity of financial instruments; and (iii) high transportation costs because the country is landlocked and the road network is severely inadequate.

19. **Private sector development is in its infancy, reflecting the continuing transition to a market economy.** Though recent positive developments, such as the resumption of privatization and an easing of the regulatory burden, are welcome, more needs to be done.<sup>6</sup> To create an environment conducive to private sector activity and to foster growth, the authorities, with staff endorsement, plan to focus on improving the investment climate, building the financial sector, and promoting trade openness:

- **An investment climate assessment (ICA) study identified obstacles to private sector growth,** among them cumbersome licensing requirements, rigid labor market regulations, costly property registration, lengthy export and import procedures, and the high cost of enforcing contracts (see box 3). The authorities pointed out that they have made progress in these areas: They have introduced a one-stop-shop to facilitate operations by new investors; established the Investors Advisory Council to allow regular consultations with the private sector; adopted an investment code that grants incentives; and passed business-friendly tax reform. Nevertheless, staff noted, foreign direct investment in Ethiopia is among the lowest in the region, and further efforts may be needed to ease the cost of doing business, starting with provision of information on a timely basis.

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<sup>5</sup> The authorities formally submitted this updated PRSP to the World Bank and the Fund on May 7, 2007.

<sup>6</sup> In 2005/06, for example, the share of private investment in the country was about 11 percent, virtually unchanged from the early 1990s; the contribution of the secondary sector to real GDP amounted to only 11 percent; and the value added in industry was still dominated by public enterprises.

### Box 3. Ethiopia: Ease of Doing Business

Ethiopia is ranked high on most indicators of ease of doing business in sub-Saharan Africa. This partly reflects recent efforts to improve administrative efficiency, including implementation of Business Process Reengineering (BPR) by the Ethiopian Investment Commission that has reduced the procedures and time needed to secure an investment license.

Yet Ethiopia is ranked 118th in the index of protecting investors, making it sixth among seven countries in the region. It is ranked 146th on registering property and 149th on trading across borders, lower than the regional average. From these perspectives, the business environment, as well as a low human capital stock, may thus explain the low level of foreign direct investment (1.6 percent of GDP in 2002–06) in Ethiopia compared to the regional average (3.3 percent of GDP).

	Ease of Doing Business Rank in the Region (2006)											FDI <sup>1</sup> (Percent of GDP)
	Total	Starting Business	Dealing with Licenses	Employing Workers	Registering Property	Getting Credit	Protecting Investors	Paying Taxes	Trading Across Borders	Enforcing Contracts	Closing Business	
<b>Ethiopia</b>	<b>97</b>	<b>95</b>	<b>59</b>	<b>79</b>	<b>146</b>	<b>83</b>	<b>118</b>	<b>31</b>	<b>149</b>	<b>82</b>	<b>55</b>	<b>1.6</b>
<b>Average in the region</b>	<b>130</b>	<b>114</b>	<b>115</b>	<b>105</b>	<b>134</b>	<b>113</b>	<b>95</b>	<b>88</b>	<b>145</b>	<b>95</b>	<b>115</b>	<b>3.3</b>
Kenya	83	111	24	68	115	33	60	127	145	67	128	0.9
Zambia	102	67	123	80	119	83	60	25	170	51	104	5.1
Uganda	107	107	110	8	166	159	60	43	160	71	44	3.0
Mozambique	140	153	103	157	105	83	83	80	141	168	126	5.1
Tanzania	142	127	172	143	157	117	99	113	67	65	105	4.0
Rwanda	158	58	133	106	134	159	162	83	175	69	151	0.3
Congo, Dem. Rep.	175	172	140	170	141	159	142	147	159	171	145	4.5

Sources: 2006 World Bank *Doing Business Survey* and IMF, *World Economic Outlook* (various issues).

<sup>1</sup> Average during 2002-2006.

- A sound, dynamic, and competitive financial sector is essential to promote growth and reduce poverty by mobilizing savings and allocating resources efficiently.** Considerable progress has been made in recent years. The authorities laid out their strategy for improving the quality of bank portfolios, which would enhance banking supervision and advocate risk-based management of credit.<sup>7</sup> The staff supported the strategy, reiterating the importance of preparing the financial system for greater integration into the international financial system. It urged the authorities to increase competition in banking to improve the efficiency of monetary policy. While the current capacity-building program with the World Bank will make a significant contribution, the authorities should consider the merits of undertaking reform of the financial sector on the basis of a comprehensive developmental FSAP.
- Trade openness and integration are fundamental to Ethiopia's development strategy.** The staff welcomed Ethiopia's plan for future WTO accession. Expanding agricultural exports could help to broaden the export base and contribute to reducing rural poverty. The authorities noted that preferences available under the U.S. African Growth and Opportunity Act would stimulate the development of nontraditional exports. As a step toward meaningful tariff reduction, staff recommended that the

<sup>7</sup> See Annex on the Soundness of the Banking System.

authorities consider lowering, or merging at a lower level, the top two tariff bands; the resulting revenue losses could be significantly reduced by removing some of the exemptions that give rise to widespread distortions.

- **Raising agricultural productivity is crucial to generating sustained increases in growth.** The PASDEP calls for a range of public investment and services to (i) expand investments in farm-to-market roads; (ii) encourage private sector involvement; (iii) build agricultural credit markets; and (iv) enhance the security of land tenure. Staff stressed the need for a comprehensive monitoring and evaluation mechanism to assess progress with, and the impact of, reforms being undertaken in collaboration with the World Bank and the AfDB.

#### IV. MEDIUM-TERM OUTLOOK, RISKS, AND CHALLENGES

20. **Based on the above-mentioned policy intentions of the authorities, preliminary staff projections indicate that the medium-term economic outlook for Ethiopia is favorable.** Real GDP growth will average about 7½ percent a year for 2007/08–2010/11, inflation is targeted to trend gradually toward single-digits, and gradual replenishment of gross official international reserves is expected to bring import coverage to about the 10–12 week target as the balance of payments improves (Table 7). The authorities feel that, given recent strong performance, these medium-term projections of the main macroeconomic variables should be considered conservative and prudent.

Medium-Term Projections (Baseline Scenario)  
(Percent of GDP, unless otherwise indicated)

	2006/07	2007/08	2008/09	2009/10	2010/11
GDP growth (annual change)	9.4	8.5	7.7	7.3	6.8
Consumer price (end period, annual change)	15.2	12.9	12.3	11.1	9.8
Fiscal balance (including grants)	-4.3	-3.8	-4.0	-3.9	-3.8
Total revenue (including grants)	23.3	24.5	23.9	23.8	23.8
Domestic revenue	17.3	18.3	18.3	18.1	18.1
External grants	6.0	6.2	5.7	5.7	5.7
Total expenditure	27.6	28.3	27.9	27.7	27.7
Recurrent expenditure	12.6	15.0	15.2	15.3	15.3
Capital expenditure	14.9	13.3	12.8	12.4	12.3
Financing	4.3	3.8	4.0	3.9	3.8
External financing	1.7	1.3	1.8	1.9	2.2
Domestic financing	2.5	2.5	2.2	2.0	1.6
Current account balance (including grants)	-5.6	-3.6	-5.7	-4.7	-5.4
Trade balance	-24.5	-24.4	-25.6	-25.5	-26.2
Gross international reserves (month of imports)	2.2	2.4	2.8	3.0	3.0
Net present value (NPV) of external debt-to-exports ratio <sup>1</sup>	40.6	48.7	53.7	58.1	61.1

<sup>1</sup> After enhanced HIPC relief. Exports of goods and services used.

21. **This baseline medium-term scenario reflects the government’s intention of reinforcing the foundations for growth to achieve the MDGs and meet PASDEP targets.** The strategy incorporated into the projections centers on consolidating



macroeconomic stability while commercializing agriculture to boost economic activity and fostering the nonfarm private sector.

22. **Although the macroeconomic objectives and the strategy laid out are appropriate, there are considerable downside risks to the medium-term outlook.** There is little margin for policy slippages, adverse weather may recur, structural constraints that are emerging would be addressed promptly, and the environment for private sector-led growth is far from fully supportive. A critical challenge for Ethiopia is to strike a judicious balance between demand-dampening measures and growth-enhancing structural economic reforms in order to consolidate macroeconomic stability.

23. **An alternative medium-term scenario, which assumes no policy efforts to address the macroeconomic imbalances and to enhance growth, shows output growth declining to about 5½ percent a year by 2010/11.** That may not be sufficient to reach the MDGs. Private investment would decline if reforms to improve the business climate do not progress. The overall fiscal deficit would increase to over 7 percent of GDP by 2010/11 if there are no further revenue-enhancing measures. Slackened policy intensity over the medium term would also contribute to pressures on prices and the balance of payments; inflation would stay above 15 percent; and official international reserves would fall to the equivalent of 1.3 month of imports.

Medium-Term Projections (Alternative Scenario Under Weak Policy Stance)  
(Percent of GDP, unless otherwise indicated)

	2006/07	2007/08	2008/09	2009/10	2010/11
GDP growth (annual change)	9.4	7.7	6.7	6.0	5.4
Consumer price (end period, annual change)	15.2	14.2	15.2	15.4	15.4
Fiscal balance (including grants)	-4.5	-5.7	-6.2	-6.6	-7.2
Total revenue (including grants)	23.2	22.2	21.5	20.6	20.1
Domestic revenue	17.2	16.7	16.6	16.0	15.7
External grants	6.0	5.5	5.0	4.6	4.4
Total expenditure	27.7	27.9	27.8	27.3	27.3
Recurrent expenditure	12.6	12.1	12.2	12.4	12.4
Capital expenditure	15.1	14.5	14.8	14.5	14.5
Financing	4.5	4.4	5.4	6.2	6.8
External financing	1.7	1.3	1.8	1.9	2.2
Domestic financing	2.8	3.0	3.6	4.3	4.5
Current account balance (including grants)	-5.8	-5.0	-6.4	-6.1	-6.0
Trade balance	-24.6	-24.8	-26.1	-26.1	-26.6
Gross international reserves (month of imports)	2.0	1.7	1.6	1.5	1.3
Net present value (NPV) of external debt-to-exports ratio <sup>1</sup>	35.5	42.8	55.1	63.9	71.7

<sup>1</sup> After enhanced HIPC relief. Exports of goods and services used.

24. **The debt sustainability analysis was updated jointly with World Bank staff on the basis of the baseline medium-term scenario and taking into account MDRI debt relief from the Fund, the World Bank, and the AfDB (see Supplement).** While external debt ratios have improved considerably with debt relief, the analyses show a moderate risk of debt distress based on stress tests. Therefore, securing grant and concessional financing

And containing domestic borrowing are vital if debt is to stay sustainable over the medium to long term. Staff urged the authorities to draw up a comprehensive public debt strategy that specifically includes public enterprise debt and contingent liabilities, and to strengthen debt management capacity.

25. **Data shortcomings continue to affect analysis of economic developments.** The shortcomings were most prominent in national accounts (where statistical discrepancy was 10 percent of GDP in 2005/06), balance of payments (where errors and omissions were equivalent to 32 percent of exports in 2005/06), and fiscal accounts (where unidentified financing reached 1.6 percent of GDP in 2005/06). The mission encouraged further efforts to improve the quality of data, including with technical assistance from donors and the Fund. In this regard, addressing the high turnover of relevant staff, defining priorities, and improving inter-agency coordination are key elements for ensuring the sustainability of statistical reform.

## V. STAFF APPRAISAL

26. **The recent growth performance in Ethiopia has been encouraging, but there are incipient macroeconomic imbalances.** Growth exceeded what was envisaged in the authorities' poverty reduction strategy, which has apparently helped significantly in reducing poverty and ultimately achieving the MDGs. Nevertheless, the recent surge in prices and dwindling official international reserves do not augur well for consolidating macroeconomic stability over the medium term.

27. **Fully aware of the risks, the authorities are attempting to address them.** They have given high priority to maintaining macroeconomic stability while reiterating the need to maintain growth momentum. Their main macroeconomic objectives over the medium term are therefore to keep growth on the current trajectory, push inflation downward to the single digits, and gradually replenish official international reserves.

28. **Achieving these objectives will require a constellation of policies to restrain domestic demand, particularly in the public sector, and intensify structural reforms.** The tightening of the fiscal stance in 2006/07 relative to the initial budget plans is therefore welcome. It incorporates new revenue measures and close monitoring of expenditures to stretch out some large projects and cut low-priority outlays, but it safeguards poverty-reducing and growth-enhancing spending. Over the medium term, it was agreed that fiscal policy needs to be anchored in net domestic borrowing by the government, which should be constrained to ensure debt sustainability and better crowd in the private sector as it takes a more prominent role in economic development.

29. **Monetary and exchange rate policies should focus on achieving the inflation and international reserves targets.** In the absence of effective indirect instruments, the authorities have relied on direct instruments, which have not been effective in curbing credit growth given the excess reserves in the banking system. However, the shift to indirect instruments for monetary policy would depend essentially on (i) the development of an

institutional framework for active open market operations; (ii) reforms in the financial sector to facilitate intermediation, strengthen risk-based management and supervision, and improve the environment for competition; and (iii) success in mopping up excess cash reserves in the banking system. A cautious approach toward interest rate flexibility while structural changes are underway is understandable, but monetary policy should be tightened significantly to keep high-inflation expectation from becoming entrenched. Furthermore, the authorities should consider the merits of undertaking financial sector reforms within the framework of a developmental FSAP.

**30. The authorities' intention to give the exchange rate more flexibility is welcome.**

The immediate priority should be to allow the exchange rate to depreciate more rapidly within the context of the de jure regime of a managed float. Structural reforms also are necessary to improve productivity and efficiency so as to strengthen external competitiveness. Under the current circumstances, including with severe deficiencies in data that impede a precise calculation of an equilibrium exchange rate, staff is of the view that the current regime is appropriate to reflect the evolving fundamental conditions.

**31. A critical medium-term challenge for Ethiopia now is to accelerate structural reforms to buttress sustainable growth.** The authorities are accurate in their perception that emerging supply constraints can only be relaxed with continued structural reforms. They should therefore continue to focus on improving the investment climate, strengthening the financial sector, and promoting trade openness.

**32. Based on the authorities' current policy intentions, the prospects are favorable for addressing incipient macroeconomic imbalances and maintaining growth momentum over the medium term.** Real GDP would continue to grow relatively fast through 2010/11, inflation should begin to trend downward, and gross official international reserves should gradually be replenished but there is no room for policy slippages. While there is space for new borrowing, Ethiopia must continue to seek concessional financing and design a borrowing strategy that incorporates long-term repayment obligations. The outlook has downside risks, such as slippages in macroeconomic policies and failure to intensify structural reforms to address bottlenecks and encourage private sector-led growth. By threatening macroeconomic stability these risks would cast a shadow over Ethiopia's growth prospects and the likelihood of achieving the MDGs.

**33. The data provided to the Fund are adequate for surveillance purposes, but major weaknesses persist and further steps should be taken to address the shortcomings in real, fiscal, and balance of payments statistics without delay.** Stepped-up efforts, with technical assistance from various sources (including the Fund), are called for. In the meantime, the authorities should be commended for taking the responsibility to compile and publish the statistical appendix for Article IV consultations as part of a pilot project launched by Fund staff.

**34.** It is proposed that the next Article IV consultation be held on the standard 12-month cycle.

Table 1. Ethiopia: Selected Economic and Financial Indicators, 2003/04–2010/11 <sup>1</sup>

	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11
					Staff proj.	Staff proj.	Staff proj.	Staff proj.
National income and prices								
(Annual percentage change)								
GDP at constant prices (at factor cost)	11.9	10.5	9.6	9.4	8.5	7.7	7.3	6.8
GDP deflator	4.2	9.6	7.4	16.0	12.6	12.3	11.4	10.2
Consumer prices (period average )	8.6	6.8	12.3	17.0	12.6	12.6	11.6	10.4
Consumer prices (end period)	1.7	13.0	11.6	15.2	12.9	12.3	11.1	9.8
External sector								
Exports, f.o.b.	24.4	41.1	18.1	9.9	13.3	7.4	9.7	8.3
Imports, c.i.f.	39.3	40.4	26.4	8.7	12.3	13.2	8.5	10.0
Export volume	28.0	21.1	5.0	10.6	11.7	7.4	9.6	7.9
Import volume	26.5	29.4	18.8	3.2	10.5	11.4	7.0	8.5
Terms of trade (deterioration – )	-14.6	8.0	5.1	-5.9	-0.1	-1.9	-1.4	-1.1
Nominal effective exchange rate (end of period)	-3.2	-1.5	-1.8	...	...	...	...	...
Real effective exchange rate (end of period)	-4.7	8.2	6.3	...	...	...	...	...
Money and credit								
(Percent of beginning-period stock of broad money, unless otherwise indicated)								
Net foreign assets	8.9	-0.3	-1.6	9.0	8.3	8.8	7.5	4.7
Net domestic assets	2.0	19.9	19.0	20.8	18.0	14.6	14.3	15.3
Net claims on the government	7.1	9.3	7.1	7.9	7.2	6.1	5.4	4.4
Credit to the nongovernment sector	3.9	20.2	13.6	16.0	14.7	12.3	12.5	14.5
Broad money	10.9	19.6	17.4	29.7	26.2	23.4	21.8	20.0
Velocity (GDP/broad money)	2.42	2.43	2.43	2.39	2.34	2.29	2.25	2.20
Interest rates (Percent at end of period)								
Minimum savings deposit rates	3.0	3.0	3.0	...	...	...	...	...
Lending rates (average)	8.9	8.8	8.6	...	...	...	...	...
Treasury bill (91-day maturity)	0.5	0.1	0.0	...	...	...	...	...
Financial balances								
(Percent of GDP, unless otherwise indicated)								
Gross domestic saving	5.4	2.6	5.2	8.1	9.8	9.8	9.7	9.4
Government saving	2.4	2.4	3.7	5.6	4.1	3.8	3.2	3.1
Private saving	3.0	0.2	1.5	2.4	5.7	6.0	6.5	6.3
Gross domestic investment	21.4	20.5	19.8	22.1	21.7	22.3	21.8	22.1
Government investment	9.0	9.1	8.4	10.1	8.9	8.8	8.5	8.5
Private investment	12.4	11.4	11.4	12.0	12.8	13.5	13.3	13.6
External current account balance, including official transfers	-4.2	-6.8	-10.4	-5.6	-3.6	-5.7	-4.7	-5.4
External current account balance, excluding official transfers	-10.2	-13.4	-16.9	-13.1	-11.5	-12.4	-12.1	-12.7
Government finances								
Revenue	17.0	15.8	16.9	17.3	18.3	18.3	18.1	18.1
Tax revenue	13.3	12.6	12.2	12.5	13.9	14.0	14.0	14.0
Nontax revenue	3.7	3.2	4.6	4.8	4.4	4.3	4.1	4.1
External grants	4.9	4.6	4.1	6.0	6.2	5.7	5.7	5.7
Expenditure and net lending <sup>2</sup>	25.1	25.2	25.4	27.6	28.3	27.9	27.7	27.7
Fiscal balance, including grants (cash basis)	-3.2	-4.7	-4.4	-4.3	-3.8	-4.0	-3.9	-3.8
Total financing	3.2	4.7	4.4	4.3	3.8	4.0	3.9	3.8
External financing	2.9	2.4	1.3	1.7	1.3	1.8	1.9	2.2
Domestic financing (including residual)	0.2	2.3	3.1	2.5	2.5	2.2	2.0	1.6
Public debt	113.6	87.1	79.8	43.2	41.7	42.2	42.4	42.4
Domestic debt <sup>3</sup>	35.8	34.2	35.0	30.1	26.7	24.3	22.3	20.7
External debt (including to Fund)	77.7	52.9	44.9	13.1	14.9	17.9	20.0	21.7
Net present value (NPV) of external debt-to-exports ratio (including to Fund)	126.2	32.2	35.5	40.6	48.7	53.7	58.1	61.1
External debt-service ratio <sup>5</sup>	6.3	4.0	5.0	4.4	4.3	3.9	3.8	3.7
Overall balance of payments (Percent of GDP)	2.4	-0.9	-1.4	2.1	1.8	1.7	0.8	-0.5
Gross official reserves (US\$ millions)	1,350	1,555	1,079	1,240	1,562	1,962	2,306	2,451
(months of imports of goods and nonfactor services of following year)	3.7	3.4	2.1	2.2	2.4	2.8	3.0	3.0
GDP at current market prices (Millions of birr)	81,755	98,398	115,589	146,970	181,822	219,809	262,302	308,431
Exchange rate (birr per U.S. dollar; period average rate)	8.62	8.65	8.68	...	...	...	...	...

Sources: Ethiopian authorities; and IMF staff estimates and projections.

<sup>1</sup> The fiscal year starts from July 8 to July 7.<sup>2</sup> Including special programs.<sup>3</sup> Whole series was revised.<sup>4</sup> After enhanced HIPC relief. Exports of goods and services used.<sup>5</sup> After enhanced HIPC relief.

Table 2. Ethiopia: General Government Operations, 2003/04–2007/08

	2003/04 <sup>1</sup>	2004/05	2005/06		2006/07		2007/08
	Act.	Act.	Budget	Act.	Budget	Staff Proj.	Staff Proj.
Total revenue and grants	17,919	20,147	29,047	24,251	34,525	34,265	44,496
Revenue	13,917	15,582	21,818	19,530	25,685	25,419	33,276
Tax revenue	10,906	12,398	15,509	14,159	18,573	18,308	25,279
Direct taxes	3,431	3,930	4,977	4,461	5,961	5,695	7,643
Indirect taxes	7,476	8,468	10,532	9,698	12,613	12,613	17,635
Domestic indirect taxes	2,200	2,721	3,645	3,111	4,375	3,998	5,165
Import duties and taxes	5,276	5,746	6,887	6,587	8,237	8,615	12,470
Nontax revenue	3,010	3,184	6,308	5,371	7,111	7,111	7,998
Grants	4,003	4,565	7,229	4,721	8,841	8,845	11,220
Emergency assistance (food and nonfood aid)	699	721	586	586	826	936	1,081
Program grants <sup>2</sup>	2,255	2,331	3,506	950	3,735	3,468	4,587
Multilateral Debt Relief Initiative <sup>3</sup>	...	...	...	989	...	495	495
Project grants	1,047	1,513	3,137	2,196	4,280	3,947	5,057
Total expenditure and net lending (cash basis) <sup>4</sup>	20,508	24,796	35,098	29,324	41,837	40,517	51,385
Recurrent expenditure <sup>4</sup>	11,965	13,229	16,182	15,234	19,270	18,581	27,273
Defense spending	2,452	2,920	3,000	3,009	3,000	3,000	3,500
Poverty-reducing expenditure <sup>5</sup>	4,045	4,968	6,203	6,493	7,690	7,690	13,613
Interest payments	1,080	1,011	1,385	1,054	1,481	1,446	1,125
Domestic interest and charges	576	525	846	621	942	918	942
External interest payments <sup>6</sup>	504	486	539	433	539	528	183
Emergency assistance (food and other emergency aid)	699	721	586	586	826	936	1,081
Other recurrent expenditure	3,689	3,609	5,008	4,091	6,273	5,510	7,954
Capital expenditure <sup>4</sup>	8,271	11,343	18,916	14,040	22,567	21,936	24,112
Central treasury	5,403	8,376	13,764	10,784	15,833	15,675	16,437
External project grants	1,047	1,513	3,137	2,196	4,280	3,947	5,057
External project loans	1,821	1,454	2,015	1,061	2,454	2,314	2,617
Of which: poverty-reducing expenditure <sup>5</sup>	6,130	9,036	13,148	11,796	17,287	17,287	19,087
Special programs <sup>7</sup>	272	224	0	50	0	0	0
Overall balance							
Including grants	-2,589	-4,649	-6,051	-5,073	-7,312	-6,252	-6,888
Excluding grants	-6,591	-9,214	-13,281	-9,794	-16,153	-15,098	-18,108
Excluding MDRI	...	...	...	-6,063	...	...	...
Financing	2,591	4,649	6,051	5,074	7,312	6,252	6,888
Net external financing	2,399	2,384	2,050	1,512	3,316	2,521	2,429
Gross borrowing	2,555	2,507	2,015	1,520	2,454	2,314	2,617
Capital budget	1,821	1,454	2,015	1,061	2,454	2,314	2,617
Program loans	293	780	0	0	0	0	0
Special programs	441	273	0	459	0	0	0
HIPC debt relief <sup>6</sup>	678	728	1,015	926	1,822	1,154	0
Amortization <sup>6</sup>	-833	-851	-980	-934	-960	-947	-188
Total net domestic financing	180	2,255	4,001	3,561	3,996	3,731	4,459
Domestic (net)	2,147	3,492	4,001	2,735	3,996	3,731	4,459
Banking system	2,155	3,156	4,001	2,876	3,996	3,731	4,459
Nonbank sources	-8	336	0	-141	0	0	0
MDRI, account held at NBE <sup>3</sup>	...	...	...	-989	0	0	0
Privatization	11	10	0	0	0	0	0
Float/unidentified financing	-1,967	-1,237	0	1,815	0	0	0
Memorandum items:							
Poverty-reducing expenditure	10,175	14,004	19,351	18,290	24,977	24,977	32,700
Direct budget support (loans plus grants, US\$ millions)	296	360	404	109	404	375	450
Multilateral debt relief initiative (US\$ millions)	...	...	...	114	0	0	...
External grants and loans (US dollars per capita)	11	11	14	10	16	16	17
Primary fiscal balance, including grants	-1,509	-3,638	-4,666	-4,019	-5,831	-4,806	-5,763
Domestic fiscal balance, including grants	-2,520	-5,039	-7,004	-5,519	-8,054	-7,373	-9,170
Gross domestic government debt	29,305	33,643	37,644	40,440	44,437	44,172	48,630

Sources: Ethiopian authorities; and IMF staff estimates and projections. The Ethiopian fiscal year ends July 7.

<sup>1</sup> The fiscal accounts include municipal spending by Addis Ababa starting in 2003/04.

<sup>2</sup> Including the disbursements under the PBS operations starting from 2005/06.

<sup>3</sup> Debt relief from the IMF under the MDRI is recorded in 2005/06. Withdrawal from the special account at the NBE is assumed to take place from FY2006/07 and FY2007/08.

<sup>4</sup> Excluding special programs (demobilization and reconstruction).

<sup>5</sup> Poverty-reducing spending is defined to include total spending on health, education, agriculture, roads, and food security.

<sup>6</sup> External interest and amortization are presented before HIPC debt relief from the World Bank and African Development Bank.

<sup>7</sup> Demobilization and reconstruction.

Table 3. Ethiopia: General Government Operations, 2003/04–2007/08  
(In percent of GDP)

	2003/04 <sup>1</sup>	2004/05	2005/06		2006/07		2007/08
	Act.	Act.	Budget	Act.	Budget	Staff Proj.	Staff Proj.
Total revenue and grants	21.9	20.5	25.1	21.0	23.5	23.3	24.5
Revenue	17.0	15.8	18.9	16.9	17.5	17.3	18.3
Tax revenue	13.3	12.6	13.4	12.2	12.6	12.5	13.9
Direct taxes	4.2	4.0	4.3	3.9	4.1	3.9	4.2
Indirect taxes	9.1	8.6	9.1	8.4	8.6	8.6	9.7
Domestic indirect taxes	2.7	2.8	3.2	2.7	3.0	2.7	2.8
Import duties and taxes	6.5	5.8	6.0	5.7	5.6	5.9	6.9
Nontax revenue	3.7	3.2	5.5	4.6	4.8	4.8	4.4
Grants	4.9	4.6	6.3	4.1	6.0	6.0	6.2
Emergency assistance (food and nonfood aid)	0.9	0.7	0.5	0.5	0.6	0.6	0.6
Program grants <sup>2</sup>	2.8	2.4	3.0	0.8	2.5	2.4	2.5
Multilateral Debt Relief Initiative <sup>3</sup>	...	...	...	0.9	0.0	0.3	0.3
Project grants	1.3	1.5	2.7	1.9	2.9	2.7	2.8
Total expenditure and net lending (cash basis) <sup>4</sup>	25.1	25.2	30.4	25.4	28.5	27.6	28.3
Recurrent expenditure <sup>4</sup>	14.6	13.4	14.0	13.2	13.1	12.6	15.0
Defense spending	3.0	3.0	2.6	2.6	2.0	2.0	1.9
Poverty-reducing expenditure <sup>5</sup>	4.9	5.0	5.4	5.6	5.2	5.2	7.5
Interest payments	1.3	1.0	1.2	0.9	1.0	1.0	0.6
Domestic interest and charges	0.7	0.5	0.7	0.5	0.6	0.6	0.5
External interest payments <sup>6</sup>	0.6	0.5	0.5	0.4	0.4	0.4	0.1
Emergency assistance (food and other emergency aid)	0.9	0.7	0.5	0.5	0.6	0.6	0.6
Other recurrent expenditure	4.5	3.7	4.3	3.5	4.3	3.7	4.4
Capital expenditure <sup>4</sup>	10.1	11.5	16.4	12.1	15.4	14.9	13.3
Central treasury	6.6	8.5	11.9	9.3	10.8	10.7	9.0
External project grants	1.3	1.5	2.7	1.9	2.9	2.7	2.8
External project loans	2.2	1.5	1.7	0.9	1.7	1.6	1.4
Of which: poverty-reducing expenditure <sup>5</sup>	7.5	9.2	11.4	10.2	11.8	11.8	10.5
Special programs <sup>7</sup>	0.3	0.2	0.0	0.0	0.0	0.0	0.0
Overall balance							
Including grants	-3.2	-4.7	-5.2	-4.4	-5.0	-4.3	-3.8
Excluding grants	-8.1	-9.4	-11.5	-8.5	-11.0	-10.3	-10.0
Excluding MDRI	...	...	...	-5.2	...	...	...
Financing	3.2	4.7	5.2	4.4	5.0	4.3	3.8
Net external financing	2.9	2.4	1.8	1.3	2.3	1.7	1.3
Gross borrowing	3.1	2.5	1.7	1.3	1.7	1.6	1.4
Capital budget	2.2	1.5	1.7	0.9	1.7	1.6	1.4
Program loans	0.4	0.8	0.0	0.0	0.0	0.0	0.0
Special programs	0.5	0.3	0.0	0.4	0.0	0.0	0.0
HIPC debt relief <sup>6</sup>	0.8	0.7	0.9	0.8	1.2	0.8	0.0
Amortization <sup>6</sup>	-1.0	-0.9	-0.8	-0.8	-0.7	-0.6	-0.1
Total net domestic financing	0.2	2.3	3.5	3.1	2.7	2.5	2.5
Domestic (net)	2.6	3.5	3.5	2.4	2.7	2.5	2.5
Banking system	2.6	3.2	3.5	2.5	2.7	2.5	2.5
Nonbank sources	0.0	0.3	0.0	-0.1	0.0	0.0	0.0
MDRI, account held at NBE <sup>3</sup>	...	...	...	-0.9	0.0	0.0	0.0
Privatization	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Float/unidentified financing	-2.4	-1.3	0.0	1.6	0.0	0.0	0.0
<i>Memorandum items:</i>							
Poverty-reducing expenditure	12.4	14.2	16.7	15.8	17.0	17.0	18.0
Import duties and taxes (as a percentage of imports)	19.3	15.2	14.3	13.7	14.6	15.3	18.0
Direct budget support (loans plus grants, as a percent of GDP)	3.1	3.2	3.0	0.8	2.5	2.4	2.5
Primary fiscal balance, including grants	-1.8	-3.7	-4.0	-3.5	-4.0	-3.3	-3.2
Domestic fiscal balance, including grants	-3.1	-5.1	-6.1	-4.8	-5.5	-5.0	-5.0
Gross domestic government debt	35.8	34.2	32.6	35.0	30.2	30.1	26.7

Sources: Ethiopian authorities; and Fund staff estimates and projections. The Ethiopian fiscal year ends July 7.

<sup>1</sup> The fiscal accounts include municipal spending by Addis Ababa starting in 2003/04.

<sup>2</sup> Including the disbursements under the PBS operations starting from 2005/06.

<sup>3</sup> Debt relief from the IMF under the MDRI is recorded in 2005/06. Withdrawal from the special account at the NBE is assumed to take place from FY2006/07 and FY2007/08.

<sup>4</sup> Excluding special programs (demobilization and reconstruction).

<sup>5</sup> Poverty-reducing spending is defined consistently with the SDPRP to include total spending on health, education, agriculture, roads, and food security.

<sup>6</sup> External interest and amortization are presented before HIPC debt relief from the World Bank and African Development Bank.

<sup>7</sup> Demobilization and reconstruction.

Table 4. Ethiopia: Monetary Survey, 2003/04–2007/08 <sup>1</sup>

	2003/04	2004/05	2005/06 <sup>2</sup>	2006/07 Proj.	2007/08 Proj.
	(Millions of birr)				
Net foreign assets	14,000	13,896	13,251	17,515	22,608
National Bank of Ethiopia (NBE)	9,181	9,670	7,312	9,269	13,514
Assets	11,665	13,477	9,389	11,480	15,952
Liabilities	2,484	3,807	2,077	2,211	2,438
Commercial banks	4,820	4,227	5,939	8,245	9,095
Assets	6,713	6,133	7,684	10,103	11,144
Liabilities	1,893	1,906	1,745	1,858	2,049
Net domestic assets	19,823	26,556	34,235	44,088	55,154
Domestic credit	31,681	41,652	50,044	61,387	74,891
Claims on government (net) <sup>3</sup>	20,009	23,156	26,040	29,771	34,230
NBE	9,383	19,071	18,804	19,418	19,515
Commercial banks	10,627	4,085	7,236	10,354	14,715
Claims on nongovernment	11,672	18,496	24,003	31,616	40,661
NBE	54	0	0	0	0
Commercial banks	11,618	18,496	24,003	31,616	40,661
Public enterprises	2,144	5,967	7,936	10,136	12,629
Private sector	9,527	12,529	16,069	21,480	28,031
Other items (net)	-11,858	-15,095	-15,810	-17,299	-19,736
Broad money	33,822	40,451	47,486	61,609	77,774
Money	18,137	21,429	24,701	31,278	39,484
Currency outside banks	7,891	10,063	11,360	13,518	17,065
Demand deposits	10,246	11,366	13,341	17,759	22,419
Quasimoney	15,684	19,022	22,784	30,332	38,290
Savings deposits	14,447	17,403	20,688	27,540	34,766
Time deposits	1,237	1,619	2,097	2,792	3,524
	(Annual change in percent of broad money at the beginning of period, unless otherwise indicated)				
Net foreign assets	8.9	-0.3	-1.6	9.0	8.3
Net domestic assets	2.0	19.9	19.0	20.8	18.0
Domestic credit	11.0	29.5	20.7	23.9	21.9
Claims on government (net)	7.1	9.3	7.1	7.9	7.2
Claims on nongovernment	3.9	20.2	13.6	16.0	14.7
Broad money	10.9	19.6	17.4	29.7	26.2
Money	4.3	9.7	8.1	13.8	13.3
Quasimoney	6.5	9.9	9.3	15.9	12.9
<i>Memorandum items:</i>					
Reserve money growth	4.0	73.9	-10.2	11.6	16.0
Money multiplier	2.6	1.8	2.3	2.7	2.9
Velocity (GDP/broad money)	2.42	2.43	2.43	2.39	2.34
Gross official foreign reserves (US\$ millions)	1,350	1,555	1,079	1,240	1,562
Net foreign assets of the banking system (US\$ millions)	1,621	1,603	1,524	1,892	2,214
Excess reserves (percent of deposits)	9.7	27.5	13.2	11.3	7.7

Sources: National Bank of Ethiopia; and IMF staff estimates and projections.

<sup>1</sup> Year ending July 7. Including commercial bank claims and liabilities to Eritrea.

<sup>2</sup> For 2005/06 government deposits at NBE reflect transfer of IMF MDRI relief into a government account; NBE foreign liabilities have been reduced by a similar amount.

<sup>3</sup> Claims on general government (federal and regional governments and other public agencies) by the banking system less deposits of the general government with the banking system.

Table 5. Ethiopia: Balance of Payments, 2003/04–2006/07 <sup>1</sup>

(Millions of U.S. dollars, unless otherwise indicated)

	2003/04	2004/05	2005/06	2006/07
Trade balance	-1,986	-2,786	-3,592	-3,891
Exports of goods	600	847	1,000	1,099
Coffee	223	335	354	363
Horticulture	0	8	22	88
Other	377	512	646	648
Imports of goods	2,587	3,633	4,593	4,990
Semi-Finished	435	665	822	820
Fuel	311	669	861	904
Capital goods	877	1,199	1,453	1,735
Of which: aircraft	126	139	68	25
Of which: Public investment related imports <sup>2</sup>	480	941	853	1,206
Consumer goods	896	986	1,282	1,317
Nonfactor services (net)	310	277	149	292
Exports of nonfactor services	894	1,011	1,105	1,391
Imports of nonfactor services	584	734	955	1,099
Income (net)	-64	-36	-38	21
Of which: gross official interest payments <sup>3</sup>	-62	-51	-62	-24
Private transfers (net)	771	1,023	1,229	1,501
Current account balance, excl. official transfers	-969	-1,522	-2,253	-2,077
(Percent of GDP)	-10.2	-13.4	-16.9	-13.1
Excluding EAL imports	-8.9	-12.2	-16.4	-12.9
Official transfers (net)	567	750	866	1,181
Current account balance, incl. official transfers	-402	-771	-1,386	-897
(Percent of GDP)	-4.2	-6.8	-10.4	-5.6
Excluding EAL imports	-2.9	-5.6	-9.9	-5.5
Capital account balance (incl. errors and omissions)	629	670	1,202	1,188
Foreign direct investment (net)	150	150	365	404
Other investment (net)	362	459	163	274
Official long-term loans	198	271	80	295
Disbursements	298	344	343	437
EAL loan	212	125	0	0
Amortization <sup>3</sup>	100	73	263	143
Other public sector long-term loans (net) <sup>4</sup>	190	193	-7	0
Other (net)	-26	-6	90	-21
Errors and omissions	117	61	674	510
Overall balance	227	-102	-184	291
Financing	-227	102	184	-291
Central bank (net; increase -)	-334	-53	275	-161
Reserves (increase -)	-420	-204	476	-161
Liabilities (increase +)	86	152	-201	0
Fund credit (net)	15	7	-1	0
Commercial banks (net; increase -)	25	70	-195	-208
Debt relief (Paris Club II and III, Naples terms, HIPC) <sup>5</sup>	82	84	105	77
<i>Memorandum items:</i>				
Exports of goods (percent change)	24.4	41.1	18.1	9.9
Export price index (percent change)	-3.6	20.0	13.1	-0.7
Export volume index (percent change)	28.0	21.1	5.0	10.6
Imports of goods (percent change)	39.3	40.4	26.4	8.7
Import price index (percent change)	12.8	11.1	7.6	5.5
Import volume index (percent change)	26.5	29.4	18.8	3.2
Gross official reserves	1,350	1,555	1,079	1,240
(Months of imports of goods and nonfactor services of following year)	3.7	3.4	2.1	2.2
Terms of trade index, percent change (1996/97 = 100)	-14.6	8.0	5.1	-5.9
MDRI debt relief			114	

Sources: Ethiopian authorities, and IMF staff estimates and projections.

<sup>1</sup> Data pertain to the period July 8–July 7.<sup>2</sup> Assuming an import content of 50 percent except for ETC (65 percent).<sup>3</sup> For 2006/07, incorporates MDRI debt relief.<sup>4</sup> Public enterprises.<sup>5</sup> Includes 1997 and 2001 Paris Club rescheduling agreements (including Russia) on Naples terms, 2002 Paris Club topping up to Cologne terms, and HIPC relief (including interim relief including estimates of relief beyond HIPC and relief on non-Paris Club debt under negotiation).<sup>6</sup> Foreign aid is defined as official transfers and inflows of loans to the government.



Table 6. Ethiopia: Millennium Development Goals

	1990	1995	1998	2001	2004
<b>Goal 1: Eradicate extreme poverty and hunger</b>					
Income share held by lowest 20%	..	..	..	9	..
Malnutrition prevalence, weight for age (% of children under 5)	..	..	..	47	..
Poverty gap at \$1 a day (PPP) (%)	..	8	..	5	..
Poverty headcount ratio at \$1 a day (PPP) (% of population)	..	31	..	23	..
Poverty headcount ratio at national poverty line (% of population)	..	46	..	44	..
Prevalence of undernourishment (% of population)	..	..	61	..	46
<b>Goal 2: Achieve universal primary education</b>					
Literacy rate, youth total (% of people ages 15-24)	43	..	..	..	..
Persistence to grade 5, total (% of cohort)	18	..	..	..	..
Primary completion rate, total (% of relevant age group)	25.5	17.9	34	41.7	50.6
School enrollment, primary (% net)	22	..	33	40	46
<b>Goal 3: Promote gender equality and empower women</b>					
Proportion of seats held by women in national parliament (%)	..	..	2	8	8
Ratio of girls to boys in primary and secondary education (%)	68.4	..	61.7	68.2	72.8
Ratio of young literate females to males (% ages 15-24)	66.1	..	..	..	..
Share of women employed in the nonagricultural sector (% of total nonagricultural employment)	40	..	..	..	..
<b>Goal 4: Reduce child mortality</b>					
Immunization, measles (% of children ages 12-23 months)	38	38	46	55	71
Mortality rate, infant (per 1,000 live births)	131	123	..	116	110
Mortality rate, under-5 (per 1,000)	204	192	..	176	166
<b>Goal 5: Improve maternal health</b>					
Births attended by skilled health staff (% of total)	..	..	..	5.6	..
Maternal mortality ratio (modeled estimate, per 100,000 live births)	..	..	..	850	..
<b>Goal 6: Combat HIV/AIDS, malaria, and other diseases</b>					
Children orphaned by HIV/AIDS	..	..	..	..	..
Contraceptive prevalence (% of women ages 15-49)	4	..	..	8	..
Incidence of tuberculosis (per 100,000 people)	128.3	..	..	..	353.4
Prevalence of HIV, female (% ages 15-24)	..	..	..	..	..
Prevalence of HIV, total (% of population ages 15-49)	..	..	..	..	..
Tuberculosis cases detected under DOTS (%)	..	15.3	23.9	33.5	35.6
<b>Goal 7: Ensure environmental sustainability</b>					
CO2 emissions (metric tons per capita)	0.1	0	0.1	0.1	..
Forest area (% of land area)	..	..	..	14	13
GDP per unit of energy use (constant 2000 PPP \$ per kg of oil equivalent)	3	2	3	3	3
Improved sanitation facilities (% of population with access)	3	..	..	..	13
Improved water source (% of population with access)	23	..	..	..	22
Nationally protected areas (% of total land area)	..	..	..	..	16.9
<b>Goal 8: Develop a global partnership for development</b>					
Aid per capita (current US\$)	19.8	15.6	10.8	17	26.1
Debt service (PPG and IMF only, % of exports of G&S, excl. workers' remittances)	38	18	10	19	6
Fixed line and mobile phone subscribers (per 1,000 people)	2.5	2.5	2.7	4.7	7.8
Internet users (per 1,000 people)	0	0	0.1	0.4	1.6
Personal computers (per 1,000 people)	..	..	0.6	1.1	3.2
Total debt service (% of exports of goods, services and income)	39	18	12	18	5
Unemployment, youth female (% of female labor force ages 15-24)	..	..	..	..	..
Unemployment, youth male (% of male labor force ages 15-24)	..	..	..	..	..
Unemployment, youth total (% of total labor force ages 15-24)	..	..	..	..	..
<b>Other</b>					
Fertility rate, total (births per woman)	6.9	6.2	5.9	5.6	5.4
GNI per capita, Atlas method (current US\$)	240	150	130	130	130
GNI, Atlas method (current US\$ billions)	12.1	8.3	7.9	8.2	9.3
Gross capital formation (% of GDP)	12.9	18	21.1	21	21.3
Life expectancy at birth, total (years)	45	44.1	42.4	42.1	42.5
Literacy rate, adult total (% of people ages 15 and above)	28.6	..	..	..	..
Population, total (millions)	51.2	56.5	61.3	65.8	70
Trade (% of GDP)	14.4	25.4	34.9	37	48

Source: World Development Indicators database, September 2006.

Table 7. Ethiopia: Medium-Term Balance of Payments Projections, 2006/07–2010/11 <sup>1</sup>  
(Millions of U.S. dollars, unless otherwise indicated)

	2006/07	2007/08	2008/09	2009/10	2010/11
Trade balance	-3,891	-4,356	-5,004	-5,412	-5,978
Exports of goods	1,099	1,246	1,338	1,467	1,588
Coffee	363	394	407	461	496
Horticulture	88	125	146	170	200
Other	648	852	931	1,007	1,093
Imports of goods	4,990	5,602	6,341	6,879	7,567
Fuel	904	991	1,150	1,259	1,380
Capital goods	1,735	1,929	2,262	2,307	2,529
Of which: aircraft	25	30	240	240	360
Of which: Public investment related imports <sup>2</sup>	1,206	1,184	1,291	1,341	1,432
Other	2,352	2,682	2,930	3,313	3,658
Nonfactor services (net)	292	457	622	765	848
Exports of nonfactor services	1,391	1,649	1,961	2,265	2,517
Imports of nonfactor services	1,099	1,192	1,339	1,501	1,669
Income (net)	21	4	0	-31	-63
Of which: gross official interest payments <sup>3</sup>	-24	-53	-73	-124	-168
Private transfers (net)	1,501	1,845	1,947	2,113	2,290
Current account balance, excl. official transfers	-2,077	-2,050	-2,435	-2,566	-2,903
(Percent of GDP)	-13.1	-11.5	-12.4	-12.1	-12.7
Excluding EAL imports	-12.9	-11.3	-11.2	-11.0	-11.2
Official transfers (net)	1,181	1,407	1,312	1,558	1,670
Current account balance, incl. official transfers	-897	-644	-1,123	-1,008	-1,233
(Percent of GDP)	-5.6	-3.6	-5.7	-4.7	-5.4
Excluding EAL imports	-5.5	-3.4	-4.5	-3.6	-3.8
Capital account balance (incl. errors and omissions)	1,188	966	1,523	1,352	1,377
Foreign direct investment (net)	404	453	497	537	580
Other investment (net)	274	512	1,025	815	797
Official long-term loans	295	512	1,025	815	797
Disbursements	437	595	1,104	1,000	1,087
EAL loan	0	0	240	240	360
Amortization <sup>3</sup>	143	83	79	185	289
Other (net)	-21	0	0	0	0
Errors and omissions	510	0	0	0	0
Overall balance	291	322	400	344	144
Financing	-291	-322	-400	-344	-144
Central bank (net; increase –)	-161	-322	-400	-344	-144
Reserves (increase –)	-161	-322	-400	-344	-144
Liabilities (increase +)	0	0	0	0	0
Commercial banks (net; increase –)	-208	0	0	0	0
Debt relief (Paris Club II and III, Naples terms, HIPC) <sup>5</sup>	77	0	0	0	0
<i>Memorandum items:</i>					
Exports of goods (percent change)	9.9	13.3	7.4	9.7	8.3
Export price index (percent change)	-0.7	1.6	-0.1	0.1	0.4
Export volume index (percent change)	10.6	11.7	7.4	9.6	7.9
Imports of goods (percent change)	8.7	12.3	13.2	8.5	10.0
Import price index (percent change)	5.5	1.7	1.8	1.5	1.5
Import volume index (percent change)	3.2	10.5	11.4	7.0	8.5
Import volume index (excluding cereals, aircraft) (percent change)	3.2	10.5	7.9	6.0	6.7
Gross official reserves	1,240	1,562	1,962	2,306	2,451
(Months of imports of goods and nonfactor services of following year)	2.2	2.4	2.8	3.0	3.0
Terms of trade index, percent change (1996/97 = 100)	-5.9	-0.1	-1.9	-1.4	-1.1

Sources: Ethiopian authorities, and IMF staff estimates and projections.

<sup>1</sup> Data pertain to the period July 8–July 7.

<sup>2</sup> Assuming an import content of 50 percent except for ETC (65 percent).

<sup>3</sup> For 2006/07, incorporates MDRI debt relief.

<sup>4</sup> Public enterprises.

<sup>5</sup> Includes 1997 and 2001 Paris Club rescheduling agreements (including Russia) on Naples terms, 2002 Paris Club topping up to Cologne terms, and HIPC relief (including interim relief including estimates of relief beyond HIPC and relief on non-Paris Club debt under negotiation).

<sup>6</sup> Foreign aid is defined as official transfers and inflows of loans to the government.

## APPENDIX. ETHIOPIA: BANKING SYSTEM SOUNDNESS

### A. Background

Banks are the major financial intermediary institutions in Ethiopia. There are 8 commercial banks (2 state-owned and 6 private) and a development bank (the National Development Bank of Ethiopia (DBE)). The microfinance sector (27 institutions) is expanding and improving access to credit—benefiting an estimated 2 million borrowers, mainly small farmers; the sector had a loan value of about Birr 2 billion (2 percent of GDP) as of June 2006. The market share of the insurance sector (9 companies) is small, with only 3 percent of the financial sector’s assets. The National Bank of Ethiopia (NBE) regulates all three sectors. There are no securities companies.

Ethiopia: Market Share of Financial Sectors (as of June 2006)  
(In percent)

	Banks <sup>1</sup>	Microfinance	Insurance
Assets	93	4	3
Deposits	98	2	--
Loans	92	8	--

Source: National Bank of Ethiopia

<sup>1</sup> Excluding the National Development Bank of Ethiopia.

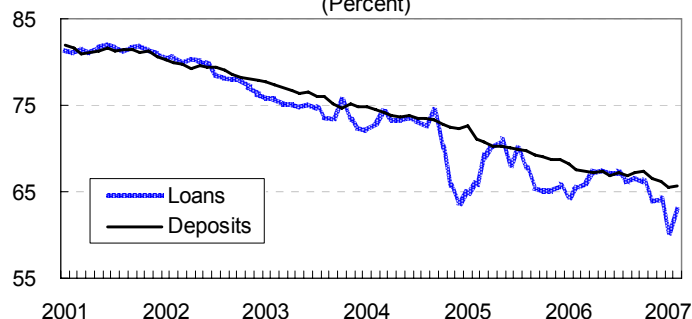
The banking system is dominated by the state-owned Commercial Bank of Ethiopia (CBE), but its market share has been gradually declining while the other commercial banks are expanding.

The banking system holds substantial reserves beyond the required 5 percent of deposits, most of which are with the state-owned CBE. This creates a hurdle for active domestic and foreign exchange interbank markets. The CBE dominates the supply side of both markets, undermining their effectiveness. Financing government deficits by issuing treasury bills to commercial banks helped reduce excess reserves from 29 percent at the end of 2005 to 14 percent a year later.

The payment system is very basic, with checks being the main noncash instrument, but efforts are underway to make it a major component of the World Bank’s new capacity-building project.

There are continuing efforts to build capacity within the central bank to effectively supervise banks and microfinance institutions, and to refine the laws and regulations to better ensure that provisions for nonperforming loans (NPLs) are sufficient, and that creditor rights are protected. Enforcement of creditor rights has been improved by the new law on foreclosure, which allows creditor banks with loans secured by a mortgaged or pledged property to foreclose by giving 30 days notice to the debtor. Banks are required to acquire collateralized

CBE Shares of Commercial Bank Loans and Deposits  
(Percent)



property after two failed auctions. The NBE is being trained by AFRITAC to strengthen capacity to assess bank risk management systems. Other areas of financial supervision are being strengthened, especially for microfinance institutions and the insurance sector.

In 2003 Ethiopia adopted a Financial Restructuring Plan (FRP) for the CBE to reduce the level of NPLs, which were 61.8 percent of outstanding loans. Based on the FRP, the government adopted benchmarks for the banking sector to achieve one of Ethiopia's Millennium Development Goals, which calls for reducing NPLs to 15 percent by June 2007.

## **B. Soundness of the Banking System**

Financial soundness indicators point to a well-capitalized, profitable, and liquid banking sector (Annex, Table 1), with profitability improving for both public and private banks. However, there is a notable performance gap between them: Private banks report higher return on assets (ROA); public banks score higher on return on equity (ROE).<sup>8</sup> Since Ethiopia does not have a stock exchange, performance has no relevance to share prices, so interest in ROE is limited to shareholders. The higher performance of the public banks on ROE may be a reflection of low levels of capital.

The banking system has become more financially sound over the last two years as supervision improved. The NPL ratio of the state-owned banks declined from 39 percent in 2004 to 22 percent in 2006; in private commercial banks it declined from 12 percent to 6 percent. Capital adequacy ratios have stayed above the minimum requirement of 8 percent of risk-weighted assets. Financial restructuring of state-owned banks is a primary reason for the decline in NPLs. However, provisioning requirements recognize the value of collateral and may significantly increase the balance sheet value of NPLs. Recent rapid credit growth is, however, raising concerns about credit quality.

Management of bank liquidity is hampered by the absence of a secondary market for treasury bills, and by the fact that both the interbank money market (where T-bills could be used as collateral) and the foreign exchange market are very thin. The NBE and the CBE are the main providers of liquidity support in situations involving Birr liquidity imbalances. Liquidity in foreign currency is also mainly provided through sales by the NBE supplemented by interbank activities between the CBE, as the supplier, and other banks.

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<sup>8</sup> The spread between bank lending and deposit rates is stable and relatively narrow. Weighted average lending rates were 8.6 percent and the rates paid on customer deposits averaged 4.0 percent. However, there are noteworthy differences between the spreads for public and private banks with respect to the lending rates, with public banks about 2 percentage points narrower than private banks.

Table 1: Ethiopia - Financial Soundness Indicators for the Banking Sector

	2003/04	2004/05	2005/06
Capital adequacy			
Capital to risk-weighted assets	11.7	11.5	11.4
Capital to assets	11.6	8.4	9.5
Asset composition and quality			
Total loans and advances to total assets	37.3	37.7	40.0
Sectoral distribution of loans to total loans			
Manufacturing	23.7	23.6	23.6
Construction	11.5	10.2	12.0
Agriculture	6.5	9.3	12.8
Transport	4.4	4.0	5.9
Hotel and tourism	1.8	1.5	1.2
Foreign exchange loans to total loans	-	-	-
Gross nonperforming loans to gross loans	27.8	20.0	14.0
NPLs net of provisions to total capital	83.1	63.7	45.4
Large exposures to total capital	135.7	179.2	138.0
Earnings and profitability			
ROA	1.6	2.0	2.8
ROE	21.8	32.1	41.1
Interest margin to gross income	35.4	31.9	35.8
Noninterest expenses to gross income	41.1	28.7	31.6
Personnel expenses to noninterest expenses	30.3	42.6	43.1
Trading and fee income to total income	43.3	47.5	45.9
Interest rate earned on loans and advances	9.0	8.7	8.7
Interest rate paid on nonbank deposits	3.9	3.9	4.0
Spread (lending minus deposit rates)	5.1	4.8	4.7
Liquidity			
Liquid assets to total assets	52.7	47.3	44.6
Liquid assets to total short-term liabilities	82.1	77.9	71.1
Total loans to customer deposits	55.3	58.8	60.0
Foreign exchange liabilities to total liabilities	0.7	0.9	0.9

Sources: National Bank of Ethiopia; and IMF staff calculations.



INTERNATIONAL MONETARY FUND  
THE FEDERAL DEMOCRATIC REPUBLIC OF ETHIOPIA  
**Staff Report for the 2007 Article IV Consultation—Informational Annex**

Prepared by the African Department

(In consultation with other departments)

Approved by Siddharth Tiwari and Carlo Cottarelli

May 18, 2007

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**Ethiopia: Relations with the Fund  
(As of March 31, 2007)**

**I. Membership Status:** Joined: December 27, 1945; Article XIV

<b>II. General Resources Account:</b>	<b>SDR Million</b>	<b>%Quota</b>
Quota	133.70	100.00
Fund holdings of currency	126.39	94.57
Reserve position	7.33	5.49

<b>III. SDR Department:</b>	<b>SDR Million</b>	<b>%Allocation</b>
Net cumulative allocation	11.16	100.00
Holdings	0.04	0.32

**IV. Outstanding Purchases and Loans:** None

**V. Latest Financial Arrangements:**

<u>Type</u>	<u>Date of Arrangement</u>	<u>Expiration Date</u>	<u>Amount Approved (SDR Million)</u>	<u>Amount Drawn (SDR Million)</u>
PRGF	Mar 22, 2001	Oct 31, 2004	100.28	100.28
PRGF	Oct 11, 1996	Oct 22, 1999	88.47	29.49
SAF	Oct 28, 1992	Nov 08, 1995	49.42	49.42

**VI. Projected Payments to Fund**

(SDR millions; based on current use of resources and present holdings of SDRs):

	<u>2007</u>	<u>2008</u>	<u>Forthcoming</u>		<u>2011</u>
			<u>2009</u>	<u>2010</u>	
Principal	0.00	0.00	0.00	0.00	0.00
Charges/interest	<u>0.35</u>	<u>0.47</u>	<u>0.47</u>	<u>0.47</u>	<u>0.47</u>
Total	<u>0.35</u>	<u>0.47</u>	<u>0.47</u>	<u>0.47</u>	<u>0.47</u>



**VII. Implementation of HIPC Initiative:**

	Enhanced Framework
1. Commitment of HIPC assistance	
Decision point date	Nov. 2001
Assistance committed	
by all creditors (US\$ millions) <sup>1</sup>	1,982.20
<i>Of which:</i> IMF assistance (US\$ millions)	60.85
(SDR equivalent in millions)	45.12
Completion point date	Apr 2004
2. Disbursement of IMF assistance (SDR millions)	
Assistance disbursed to the member	45.12
Interim assistance	10.28
Completion point balance	34.84
Additional disbursement of interest income <sup>2</sup>	1.54
Total disbursements	46.66

**VIII. Implementation of Multilateral Debt Relief Initiative (MDRI):**

1. MDRI-eligible debt (SDR million) <sup>3</sup>	112.07
Financed by: MDRI Trust	79.66
Remaining HIPC resources	32.41

## 2. Debt relief by facility (SDR millions)

Delivery Date	Eligible Debt		
	GRA	PRGF	Total
January 2006	N/A	112.07	112.07

<sup>1</sup> Assistance committed under the original framework is expressed in net present value (NPV) terms at the completion point, and assistance committed under the enhanced framework is expressed in NPV terms at the decision point. Hence, these two amounts cannot be added.

<sup>2</sup> Under the enhanced framework, an additional disbursement is made at the completion point corresponding to interest income earned on the amount committed at the decision point but not disbursed in the interim.

<sup>3</sup> The MDRI provides 100 percent debt relief to eligible member countries. Grant assistance from the MDRI Trust and HIPC resources provide debt relief to cover all debt owed to the Fund as of the end of 2004 that is still outstanding when the member qualifies for debt relief.

## **IX. Safeguards Assessment**

According to Fund policy, an assessment of the National Bank of Ethiopia (NBE) was completed on September 12, 2001, with respect to the Poverty Reduction and Growth Facility arrangement approved on March 22, 2001. The NBE has made progress in implementing the recommendations of the safeguards assessment.

## **X. Exchange Rate Arrangement**

The de facto exchange rate regime was classified as a conventional peg (on April 1, 2006), in light of the recent market developments. Though the authorities describe the de jure exchange rate regime as a managed float with no predetermined path for the exchange rate, the Birr has been relatively stable against the U.S. dollar. Furthermore, the NBE supplies foreign exchange to the market based on plans established at the beginning of each fiscal year that took into account estimates of likely supply and demand. The transaction-weighted average interbank market exchange rate on May 9, 2007, was Br 8.8887 = US\$1.

Ethiopia currently maintains four restrictions on the payments and transfers for current international transactions, which relate to (a) the tax certification requirement for repatriation of dividend and other investment income; (b) restrictions on repayment of legal external loans and supplies and foreign partner credits; (c) rules for issuance of import permits by commercial banks; and (d) the requirement to provide a clearance certificate from NBE to obtain import permits. These restrictions are inconsistent with Article VIII, Section 2(a), of the IMF's Articles of Agreement and remain unapproved.

## **XI. Article IV Consultation**

Ethiopia is on the standard 12-month consultation cycle. The Executive Board concluded the last Article IV consultation on March 17, 2006 (Country Report No. 06/122; EBM/06/26).

## **XII. Technical Assistance (2002—present)**

<b>Department</b>	<b>Purpose</b>	<b>Time of Delivery</b>
STA	Multisector	January 2002
MAE	Financial sector reform	February 2002
FAD	Tax administration	February 2002
STA	Fiscal and monetary accounts	May 2002
LEG	VAT law	May 2002
MAE	Payment system	May–June 2002
FAD	Improving fiscal reporting under decentralization	July 2002
FAD	Tax administration	July 2002
MAE	Accounting and internal audit of central bank	August 2002
FAD	Tax administration and fiscal decentralization	November 2002
MAE	Accounting and internal audit of central bank	November–

		December 2002
FAD	Tax and customs administration reforms	June–July 2003
STA	Reconciliation of fiscal and monetary accounts	August 2003
MFD	Monetary operations	October 2003
MFD	Plan for restructuring the CBE	November 2003
STA	Monetary and financial statistics mission	January–February 2004
STA	Balance of payments statistics	April 2004
MFD	Payments system	May 2004
MFD	Bank supervision	July 2004
STA	Monetary and financial statistics	September 2004
STA	Producer price index	October 2004
FAD	Modernization of tax administration	November 2004
FAD	Program/performance budgeting	January–February 2005
STA	Balance of payments statistics	January–February 2005
MFD	Bank supervision	June–July 2005
STA	Balance of payments statistics	July 2005
STA	Government finance statistics	August 2005
MCM	Bank supervision	February 2006
MCM	Modernization of payment systems	March 2006
STA	Consumer price data	March 2006
FAD	Tax policy assessment	May 2006

### **XIII. Resident Representative**

The IMF has had a resident representative office in Addis Ababa since 1993. The current Senior Resident Representative, Mr. Arnim Schwidrowski, took up the post in January 2006.

## **Ethiopia: Relations with the World Bank**

(As of April 2007)<sup>1</sup>

### **A. Partnership in Ethiopia's Development Strategy**

1. Bank and Fund share joint responsibility for supporting financial sector, taxation, decentralization, and public expenditure reforms. The Bank leads the policy dialogue on structural reforms relevant to economic growth and poverty reduction, including rural development, infrastructure, private sector development (PSD), human development, governance, protecting basic services delivery at the local level, and vulnerability.<sup>2</sup> The dialogue is supported by an extensive analytical agenda.

### **B. Areas of Common Interest to Bank and Fund**

2. **Preparation and Implementation of the PRSP.** In January 2007, the government presented the final draft of the second PRSP, an ambitious strategy called the Plan for Accelerated and Sustained Development to End Poverty (PASDEP), covering 2005/06–2009/10. The Ethiopian Parliament endorsed the strategy in 2006, implementation has begun, and an Annual Progress Report on the first year of implementation is expected within a few months. Bank and Fund collaborated in supporting formulation of the policy and the reform agenda needed to underpin the Plan for Sustainable Development to End Poverty (PASDEP). Together with the donor community, the Bank provided feedback on the draft PASDEP, and work is beginning on a Joint Staff Advisory Note (JSAN) to be sent to the Boards of the Bank and the Fund.

3. **Macroeconomic policy, private sector development, and the financial sector.** Bank and Fund cooperate closely in discussing macroeconomic policy with the government, particularly in relation to the impact of the current macroeconomic situation and its implications for eventual scaling up to achieve the MDGs. The Article IV consultation and subsequent IMF reviews of macroeconomic performance are the most important input for dialogue on macroeconomic issues within the context of the Protection of Basic Services (PBS) operation. Bank and Fund have worked together on the DSA. With reference to Ethiopia's banking sector reforms, the two staffs are working in complementary areas in the context of the Bank- approved Financial Sector Capacity Building grant (US\$15 million) on future reforms and on consolidating central bank supervisory and monetary policy functions. The private sector development agenda is being elaborated, with recent efforts focusing on restructuring the Private Sector Capacity Building operation, and completing in-depth value chain analysis for a number of sectors, including leather manufacturing, oil and seeds, and floriculture.

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<sup>1</sup> For any questions, please contact Caterina Ruggeri Laderchi at the World Bank (202.458.4020).

<sup>2</sup> Table 1 on IDA portfolio composition (Section C below) provides details on engagement in these areas.

4. **Public sector reforms.** Bank and Fund have been supporting the government's decentralization program with a view to improving the working of the civil service and local service delivery, particularly incentives for regional and local performance in the formula for subnational transfers of public resources. The Bank is also providing assistance for civil service reform, tax and customs administration reform, legal reforms, and urban management through the Public Sector Capacity Building Project (US\$100 million) approved by the World Bank Board in May 2004 and now operational.

5. **Public expenditure management.** Traditionally the Fund has been an active participant in Bank-coordinated annual public expenditure reviews (PERs). In 2005/06 the government, the Bank, the Fund, and Joint Budget Support (JBS) donors introduced the first annual Joint Budget and Aid Review (JBAR) as part of a new dialogue about the government's planning and budgeting cycle. This instrument, together with the fiduciary assessment, replaced the PERs. Since May 2006, the scope of the JBAR has been refined and two parts of the process identified.

6. Part I, which has been subsumed into the due diligence requirements for the Protection of Basic Services (PBS) project,<sup>3</sup> has become the main method of information exchange and dialogue between development partners and the government relating to PBS. The PBS has generated a wealth of previously unavailable subnational fiscal data, which will be analyzed and used to guide future Fund and Bank activities. It is expected that, together with the core information-sharing activities, Part I will also investigate selected topics on a rotating basis. The first JBAR review that took place in October 2006 led to very informative discussions on financing and other aspects of the health sector, including discussions on decentralization. A third JBAR is scheduled for May 2007, with a focus on agriculture and rural development.

7. Part II of the JBAR process will have deeper analytical content, resulting in annual reports. The reports will explore the rich analytical agenda underlying the relation between public expenditure and poverty reduction, in conjunction with other economic and sector works (ESWs). Issues to be examined in the near future are the costs of decentralization, public efficiency and equity in infrastructural sectors, and the quality of intrasectoral allocations.

8. **Fiduciary assessments.** The Ministry of Finance and Economic Development (MOFED) conducted a fiduciary assessment in 2004/05 jointly with JBS donors and the Bank, the first of a series of annual fiduciary assessments (FAs). The FA for 2006/07 is now underway. Like the Public Expenditure and Financial Accountability (PEFA) initiative, FAs are intended to consolidate various reviews of expenditure management systems in Ethiopia. Aspects of the PER related to institutional and intergovernmental fiscal design issues, the Country Financial Accountability Assessment (CFAA), and the Country Procurement Assessment Report (CPAR) will now appear in the FAs.

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<sup>3</sup> PBS currently accounts for about 28 percent of development assistance to Ethiopia and the quarterly findings of the JBARs trigger donor disbursements.

9. **Millennium Development Goals.** Bank and Fund have coordinated their work on issues related to scaling up to meet the MDGs, particularly the assessment of the government's macroeconomic analysis and financing strategy. The Bank, together with UN agencies in Ethiopia and the U.N. Millennium Project, has supported the government in assessing sectoral needs to estimate the cost of the investments required to put Ethiopia on a path to meet the MDGs. A synthesis report was issued in December 2005. The government has grounded its macroeconomic scenarios for the PASDEP in the planning done for the whole of the MDG period in the synthesis report. Adjustments were made after dialogue during the budget process, particularly to adjust the investment plans to the expenditure ceilings of the Medium-term Economic and Financing Framework (MEFF).

10. **Debt sustainability analysis and the Enhanced HIPC Initiative.** The Boards of the Bank and the Fund agreed on April 20, 2004, that Ethiopia had reached the HIPC completion point, making irrevocable the US\$1.3 billion of NPV debt relief envisaged at the decision point in November 2001. The Boards also approved an exceptional topping-up of debt relief by an additional US\$0.7 billion in NPV terms because of exogenous factors, particularly changes in the discount rate and exchange rate since the decision point, that fundamentally changed Ethiopia's economic circumstances and adversely affected its debt sustainability. MDRI debt relief with an NPV of approximately US\$1.5 billion was approved by the IMF board on December 21, 2005, and by the World Bank board on March 28, 2006. Bank and Fund staffs updated the DSA before the completion point, for the MDRI, and for the present 2007 Article IV consultation staff report.

11. **Statistical issues.** Both institutions have been providing technical assistance to the government on data and statistics. The Fund has focused on the macroeconomic side and the Bank on improving the data on poverty and social indicators for monitoring of the outcomes of Sustainable Development and Poverty Reduction Program (SDPRP)/PASDEP programs. Further work related to increasing accountability and transparency and fostering structured learning through evaluation—a priority identified in the PASDEP—is being planned.

12. **Financial sector development.** The Bank has provided funds for the National Bank of Ethiopia (NBE) capacity building in banking and insurance regulation and supervision; economic research; payments system modernization; improving credit referencing; accounting and auditing; and developing the capital market infrastructure under a capacity building project. The project has been designed to be carried out in close collaboration with the Fund (Monetary and Capital Markets Department and AFRITAC East) to avoid TA gaps and overlaps.

### C. Bank Group Strategy

13. The Interim Country Assistance Strategy (ICAS) for Ethiopia, discussed in May 2006 and covering FY2006 (July 1–June 30), focuses on good governance and growth as at the center of Bank support to Ethiopia. The ICAS aims to deepen support in (i) core governance—public administration, decentralization, and public financial management; (ii) fair and accountable provision of basic services; (iii) promotion of free enterprise;

(iv) improvement of agricultural productivity; and (v) development of infrastructure to nurture the growth of small towns and growth corridors. A new CAS is expected to go to the board in the second quarter of 2007/08.

14. As of April 30, 2007, IDA's portfolio of operations in Ethiopia comprised 20 active projects with total net commitments of US\$1,796 million and an undisbursed balance of US\$1,287 million (see table 1). In January 2006, there were 22 active projects, with total net commitments of US\$1,614 million and an undisbursed balance of US\$939 million. Total disbursements to Ethiopia amounted to US\$301 million in 2005/06 (US\$157 million in grants), compared with US\$373 million in 2005/06 (US\$195 million in grants) and US\$422 million in 2004/05 (US\$179 million in grants).<sup>4</sup>

Table 1. IDA Ethiopia Portfolio Composition

Project Name	IDA Original Amount in U.S. \$ million	IDA Undisb. <sup>1</sup>
ET- APL2 Product Safety Nets (FY07)	175	176.8
ET- Cap. Building for Agric Serv (FY06)	54	47.1
ET-2nd Multi-Sectoral HIV/AIDS SIL (FY07)	30	30.0
ET-Agr Research & Training SIL (FY98)	60	1.4
ET-Cultural Heritage LIL (FY02)	5	2.4
ET-Dec Serv Del CB (FY03)	26.2	16.3
ET-Demob & Reinteg ERL (FY01)	170.6	12.9
ET-Electricity Access (Rural) Expansion	133.4	138.6
ET-Energy Access SIL (FY03)	132.7	138.9
ET-Financial Sector Cap Bldg. Project	15	15.2
ET-Food Security SIL (FY02)	85	62.8
ET-ICT Assisted Dev SIM (FY05)	25	22.7
ET-Pastoral Community Dev APL (FY03)	30	3.6
ET-Post Secondary Education SIL (FY05)	40	35.9
ET-Priv Sec Dev CB (FY05)	24	21.9
ET-Protection of Basic Services (FY06)	215	92.9
ET-Pub Sec Cap Bldg Prj (FY04)	100	60.1
ET-RSDP APL1 (FY03)	126.8	85.0
ET-Road Sec Dev Prgm Ph 2 Supl 2 (FY05)	248.2	221.1
ET-Water Sply & Sanitation SIL (FY04)	100	88.1

Note: Excludes GEF projects.

<sup>1</sup> Undisbursed balance may exceed IDA U.S. dollar-denominated commitment due to SDR appreciation since commitment.

<sup>4</sup> Note that the decrease in total disbursements in FY2006 reflects, among other things, the Bank's decision to freeze quick-disbursing budget support through the PRSC instrument.

## **Ethiopia: Relations with the African Development Bank**

(As of April 2007)<sup>1</sup>

### **A. Partnership in Ethiopia's Development Strategy**

1. The assistance provided by the African Development Bank Group to Ethiopia since 2002 has been anchored in the country's PRSP. Building on the achievements of the first PRSP, Ethiopia has produced its second, the Plan for Sustainable Development to end Poverty (PASDEP), which is a home-grown development strategy covering

2005/06–2009/10. The final draft of the PASDEP was presented to donors in January 2007. The AfDB provided comments on the draft jointly with other Development Assistance Group (DAG) donors. The AfDB will collaborate with the Fund, the World Bank, and other donors in monitoring progress in PASDEP implementation through the Annual Progress Report.

### **B. Areas of Common Interest to the AfDB, the World Bank, and the Fund**

2. **Preparation and implementation of the PRSP.** The AfDB will work closely with both the Fund and the World Bank in supporting implementation of PASDEP and in policy dialogue around structural reforms necessary for growth and poverty reduction, including private sector development and public expenditure reform. The realization of Ethiopia's ambitious growth agenda in the PASDEP requires investment in infrastructure and productivity-enhancing programs in the rural sector. The AfDB is supporting Ethiopia in these areas in order to help create an enabling environment for sustained growth and poverty reduction. Macroeconomic stability is of central importance for the effectiveness and long-term sustainability of current development efforts and to improve prospects for scaling up of aid to attain the MDGs. Fund assessments of macroeconomic performance conducted through Article IV consultation and surveillance missions are important inputs into the AfDB country dialogue and programming process. Building on these assessments, the AfDB will cooperate with the Fund, the World Bank, and other donors to ensure that external aid is effective in promoting growth and reducing poverty in Ethiopia. The focus will be on policy actions to promote fiscal sustainability and enhance the efficiency of pro-poor and pro-growth public expenditure in PASDEP priority areas, such as infrastructure.

3. **Macroeconomic policy, private sector development, and the financial sector:** The AfDB participated in the 2007 Article IV Consultation mission as part of its cooperation with the Fund. In future, the AfDB and the Fund will seek to deepen their cooperation based on a shared commitment to help Ethiopia achieve sustained growth and reduce poverty within a stable macroeconomic framework. The AfDB is among the donors providing support for the

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<sup>1</sup> For any questions, please contact Peter Mwanakatwe ([216 7110 2494]) at the African Development Bank.



Protection of Basic Services (PBS) program using country systems and underpinned by macro dialogue. Fund surveillance missions will provide a critical input into the PBS macro dialogue, which forms part of the Joint Aid and Budget Review (JBAR). Both the AfDB and the Fund recognize the importance of private sector development and a dynamic financial sector for enhancing the competitiveness of the Ethiopian economy and promoting broad-based growth. The AfDB is supporting private sector development in Ethiopia by financing infrastructure projects and capacity building for the privatization of public enterprises.<sup>2</sup> It is also providing support to rural micro-financial institutions (MFIs) to improve rural access to financial services and build the capacity to regulate and supervise rural MFIs. The Fund's policy advice on financial sector reform will reinforce ongoing efforts to improve financial intermediation, including the World Bank's Financial Sector Capacity Building Project.

4. **Public expenditure management:** Fiscal governance is an area of common interest to the Fund, AfDB, and other donors because it lies at the core of aid effectiveness. The AfDB, the World Bank, and other donors are engaged in dialogue with the Ethiopian authorities on public expenditure management with the objective of ensuring that budgetary allocations reflect PASDEP priorities for growth, poverty reduction, and human development, and that increased pro-poor spending is translated into improved development outcomes. The AfDB and other donors are undertaking joint efforts to support improvements in Ethiopia's fiduciary systems and enhance accountability in the management of public resources through improved fiscal reporting. These efforts are underpinned by diagnostic work, including the Public Expenditure and Financial Accountability (PEFA), which is a due diligence requirement of the AfDB and other PBS donors. Efforts to strengthen fiscal transparency and accountability in the context of PBS will complement the Fund's technical assistance in this important area.

5. **Millennium Development Goals:** The AfDB, the World Bank, and the Fund share a commitment to help Ethiopia achieve rapid progress toward the MDGs while maintaining macroeconomic stability and keeping debt sustainable. The AfDB will collaborate with both the Fund and the World Bank in helping Ethiopia to follow a sustainable path toward the MDGs. This will involve further analytic work on the macroeconomic implications of scaled-up assistance for the MDGs and the design of measures to help Ethiopia build its capacity to absorb increased aid. The AfDB will also continue to support sector investment programs targeted at the MDGs, such as rural water and sanitation.

6. **Enhanced HIPC Debt Relief and the MDRI:** Ethiopia reached the completion point under the enhanced HIPC Initiative in April 2004. In May 2004, its Board approved the AfDB contribution to HIPC debt relief amounting to US\$513.36 million in nominal and US\$339.46 million in NPV terms. Following the G8 decision in Gleneagles in July 2005 to

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<sup>2</sup> This refers to the Privatization Technical Assistance Project being executed by PPESA (US\$4.50 million)

cancel the debt owed by HIPC's to multilateral institutions, the AfDB Board on April 19, 2006 approved cancellation of UA 587.70 million (equivalent to US\$876 million) in debt under the multilateral debt relief initiative (MDRI). The debt cancellation became effective on September 30, 2006. The MDRI debt relief provided by the AfDB, the World Bank, and the Fund has created fiscal space that Ethiopia will use to increase pro-poor and pro-growth spending. The AfDB and the World Bank are tracking use of the savings generated from debt relief through the Joint and Aid Budget Reviews.

7. **AfDB Group Operations:** The AfDB's active portfolio comprises 23 operations with a total commitment of UA 661.72 million (about US\$980 million). This amount consists of UA 496.60 million (US\$740 million) in concessional loans and UA 165.12 million (US\$240 million) in grants. The active portfolio includes projects in agriculture, infrastructure, and the social sector. The portfolio also includes the Protection of Basic Services Grant of UA 79.42 million (US\$117 million) approved by the Board on December 20, 2006. In FY 2006, the Bank disbursed a total amount of UA 88.87 million (US\$131 million). Disbursement flows in FY 2007 are projected to increase substantially as a result of the PBS, which is a quick disbursing operation.

8. **AfDB Group Strategy:** The AfDB's Country Strategy Paper (CSP) for 2006–2009, approved by the Board on September 6, 2006, is aligned to Ethiopia's new PRSP, the PASDEP. The CSP was prepared through a participatory process involving a broad range of stakeholders. The DAG, which includes the Fund and the World Bank, was consulted when the CSP was being prepared and before it was finalized. The overarching goal of the AfDB's medium-term assistance strategy is to promote growth and reduce poverty. The pillars of the strategy are: agricultural transformation; infrastructure development; and governance. The focus of AfDB support to agriculture is irrigation, which is vital to enhance Ethiopia's capacity to mitigate the impact of droughts. The priorities for infrastructure are rehabilitation and upgrading of roads to better connect areas of high agriculture potential with markets; rural electrification and development of hydro power; and water and sanitation. The emphasis with respect to governance is on more accountability and transparency in the public sector to ensure improved delivery of basic services.

9. **Statistics:** Ethiopia is among the AfDB member countries receiving statistical capacity-building support through the Africa Region International Comparison Program (ICP), which the AfDB coordinates. In 2003, the ICP conducted a country statistical pre-assessment for Ethiopia. Based on this pre-assessment and the request from the government, capacity-building support to the Central Statistics Authority (CSA) and the National Accounts Department of Ministry of Finance and Economic Development (MoFED) was approved. The support to both involves building capacity in price and expenditure statistics for ICP through by providing computers, training, and technical assistance.

## Ethiopia: Statistical Issues

### General

1. Data provided to the Fund are adequate for surveillance purposes, but there are shortcomings in real, fiscal, and balance of payments statistics. Ethiopia participates in the General Data Dissemination System (GDDS). Its metadata were first posted on the Fund's Dissemination Standards Bulletin Board (DSBB) in November 2002 and were partially updated in May/June 2006. Ethiopia has agreed to participate in the fiscal and monetary modules of the successor GDDS project for Anglophone Africa.
2. The authorities have agreed to assume responsibility for the Statistical Appendix for Article IV Consultations commencing in 2008, as part of the pilot project launched by the African Department of the IMF. The 2007 Statistical Appendix will be posted on the National Bank of Ethiopia (NBE) website (<http://www.nbe.gov.et/>) prior to the IMF Board meeting to consider the 2007 Article IV Consultations.

### Real sector

3. A new series of GDP estimates (1995/96–2005/06) updated the base year from 1980/81 to 1999/2000. However, there is scope for improving the quality of source data because some internal consistency issues remain. First, the quality of GDP estimates by industry is affected by the poor coverage of construction activities. Second, while some progress has been made in making GDP estimates by final expenditure consistent with output-based measures, there remain substantial shortcomings, particularly in the estimation of private consumption and fixed capital formation. The statistical discrepancy in GDP estimates by expenditure categories has been soaring in recent years. The authorities, with technical assistance from the Africa Regional Technical Assistance Center (AFRITAC East), are working to address these discrepancies by preparing supply and use tables. Follow-up technical assistance from AFRITAC East on the CPI is planned.

### Public finances

4. Despite progress in 2003 in eliminating discrepancies between data on the domestic and foreign financing of the budget deficit and the monetary accounts, significant discrepancies in recent years continue to complicate assessment of fiscal developments. Progress has been made in improving the quality and coverage of reporting on the consolidated general government and consolidating federal and regional budgets—inclusive of all extrabudgetary funds and accounts—within the decentralization of fiscal powers to woredas (districts). Ensuring the integrity of consolidated budget reporting will be a continuing task. Comprehensive information on the operations and financial position of public enterprises is not available. Fiscal data for the central government for 2002 were reported for the 2005 *Government Finance Statistics Yearbook (GFSY)*. The authorities recently submitted 2003 data, albeit with several problems. No fiscal data is provided to the

Statistics Department (STA) of the IMF for publication in the *International Finance Statistics*.

### **Monetary accounts**

5. Two STA technical assistance missions in 2004 found that the quality of monetary and financial statistics was compromised by methodological problems. The missions recommended correcting certain misclassifications of accounting data, helped the central bank compile standardized report forms (SRFs) for reporting monetary statistics to STA, and worked with the authorities and AFR to establish an integrated monetary database (IMD). The follow-up mission in September 2004 finalized the IMD. The authorities then provided SRF-based data for the NBE and other depository corporations to STA until December 2004. At present, there is a need for the NBE to resume data submissions based on the SRF and IMD framework.

### **Balance of payments**

6. Balance of payments data still require improvements on coverage, valuation, timing, and classification of transactions. From 2004 to 2006, four balance of payments statistics missions were completed as part of the GDDS project for Anglophone Africa. With assistance from experts, the authorities drew up plans to publish data consistent with the fifth edition of the *Balance of Payments Manual*. Questionnaire design and data collection procedures have since improved, and new methods were introduced for c.i.f./f.o.b. valuation adjustments for imports, external aid, trade credit, and bank financial account transactions. The authorities have expressed interest in having a resident expert to help them to address remaining shortcomings.

### **Social indicators**

7. Data on poverty are derived from household surveys regularly conducted by the Central Statistical Authority.<sup>1</sup> The World Bank has also produced reports on “Education and Health Sector Development Programs” and the “Poverty and Policies for the New Millennium Report” (1999), both of which contain data on the poverty situation. On the basis of this information, the government, with assistance from the World Bank, has constructed indicators for measuring poverty reduction, including income and expenditure per capita, income inequality, literacy, malnutrition, and infant/child mortality. During 2004/05 the authorities conducted a number of surveys to measure household welfare, including (i) a participatory poverty assessment; (ii) the Household Income, Consumption and Expenditure Survey (HICES); and (iii) a welfare monitoring survey. The data are currently being

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<sup>1</sup> Examples of regular surveys are the Household Income, Consumption, and Expenditure Survey (every five years) and the Welfare Monitoring Survey (every three years). Other household and consumption surveys have been carried out by the University of Addis Ababa in collaboration with Oxford University.

processed. There is no adequate data on prevalence rates of HIV/AIDS, especially among the rural population, and it is not clear whether food consumption among people living in drought-prone areas is properly monitored. The welfare monitoring survey conducted in 2004/05 is expected to produce indicators relating to HIV/AIDS.

**ETHIOPIA: TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE**  
(As of April 5, 2007)

	Date of Latest Observation	Date Received	Frequency of Data <sup>6</sup>	Frequency of Reporting <sup>6</sup>	Frequency of Publication <sup>6</sup>
Exchange rates	January 9, 2007	January 2007	D	D	D
International reserve assets and reserve liabilities of the monetary authorities <sup>1</sup>	December 2006	February 2007	M	M	M
Reserve/base money	December 2006	February 2007	M	M	M
Broad money	December 2006	February 2007	M	M	M
Central bank balance sheet	December 2006	February 2007	M	M	M
Consolidated balance sheet of the banking system	December 2006	February 2007	M	M	M
Interest rates <sup>2</sup>	December 2006	February 2007	M	M	M
Consumer Price Index	December 2006	February 2007	M	M	M
Revenue, expenditure, balance, and composition of financing <sup>3</sup> – general government <sup>4</sup>	December 2006	February 2007	Q	Q	Q
Revenue, expenditure, balance, and composition of financing <sup>3</sup> – central government	December 2006	February 2007	Q	Q	Q
Central government and central government-guaranteed debt <sup>5</sup>	2005/06	February 2007	A	On Mission	A
External current account balance	July 2006	February 2007	Q	Q	Q
Exports and imports of goods and services	July 2006	February 2007	Q	Q	Q
GDP/GNP	2005/06	February 2007	A	On Mission	A
Gross external debt	2005/06	February 2007	A	On Mission	A

<sup>1</sup> Includes reserve assets pledged or otherwise encumbered and net derivative positions.

<sup>2</sup> Both market-based and officially determined, including discount rates, money market rates, and rates on treasury bills, notes, and bonds.

<sup>3</sup> Foreign, domestic bank, and domestic nonbank financing.

<sup>4</sup> The general government consists of the central government (budgetary funds, extrabudgetary funds, and social security funds) and state and local governments.

<sup>5</sup> Including currency and maturity composition.

<sup>6</sup> Daily (D), weekly (W), monthly (M), quarterly (Q), annually (A).

INTERNATIONAL MONETARY FUND AND  
INTERNATIONAL DEVELOPMENT ASSOCIATION

THE FEDERAL DEMOCRATIC REPUBLIC OF ETHIOPIA

**Joint IMF/World Bank Debt Sustainability Analysis 2007**

Prepared by the staffs of the International Monetary Fund and  
the International Development Association

Approved by Carlo Cottarelli and Siddharth Tiwari (IMF) and  
Sudhir Shetty and Mark Thomas (IDA)

May 22, 2007

**I. EXTERNAL DEBT SUSTAINABILITY ANALYSIS**

**In recent years Ethiopia has benefited from significant debt relief, which has helped to ensure that its debt is sustainable.** HIPC debt relief in 2004 and MDRI relief in 2006 lowered Ethiopia's debt stock by about US\$6 billion (about 40 percent of GDP), improving its debt sustainability outlook substantially. Indeed, as of the beginning of 2006/07, the net present value (NPV) of debt in relation to output stood at 6 percent and to exports at 36 percent, far below the thresholds suggested by the debt sustainability framework (DSF) developed by the World Bank and the Fund.

**The DSA shows Ethiopia at moderate risk of debt distress.** While the debt burden indicators are below the policy dependent-thresholds for the whole projection period in the baseline, one stress test reaches the threshold in terms of debt to exports (Figure 1). In the baseline scenario, the NPV of debt to exports is projected to reach about 60 percent in five years and then hold there over the long run; this is well below the prudent threshold (150 percent of exports) set in connection with the DSF for a country classified as a "medium performer" based on the World Bank's Country Policy and Institutional Assessment rating (2003-2005). The NPV of debt to GDP is projected to level out at about 15 percent by 2025/26, also well below the prudent threshold of 40 percent of GDP. Debt service is manageable throughout the period, rising only to 3 percent of exports in 2025/26.

**Over the medium term the debt profile based on historical parameters is less favorable in terms of output but comparable to the baseline scenario in terms of exports.** The ratio of debt to GDP based on historical patterns is considerably less favorable than the baseline forecast. This is because the average annual growth rate in U.S. dollars for 1995–2005 period was only 5 percent but it is projected to average almost 8 percent over the next two decades. Debt stabilizes at about 70 percent of exports in the historical scenario, slightly higher than in the baseline scenario. This is attributable to the fact that higher debt financing is needed to cover the average current account deficit for the 1995–2005 period of 3.3 percent of GDP (used as the basis for the historical scenario) than for the projected current account deficit of 2 percent for the 2009–25 period.

### **Box 1. Macroeconomic Assumptions for the Baseline Scenario**

**Real GDP** grows annually at about 8 percent until 2010/11, falling to 7 percent thereafter.

**Exports of goods and services** are projected to grow in volume at an annual rate of about 9 ½ percent between 2007/08 and 2010/11 but export prices are projected to remain flat. Thereafter, exports grow at 11 ½ percent because prices are assumed to improve.

**The current account deficit** (before official transfers) is projected to decline from 17 percent of GDP to 12 ½ percent through 2010/11 and to improve further to average out at 7 percent of GDP over the long term. However, official international **reserves coverage** is projected to be at the lower end of the target of 10–12 weeks of imports over the next five years because of high import growth but then rise to 5 months of imports by 2025/26.

**Foreign direct investment** is envisaged to average about 2 ½ percent of GDP through 2010/11 and rise to 2 ¾ percent of GDP thereafter.

**Loan financing on concessional terms** is projected to average about 4 percent of GDP annually through 2010/11 but then decline to below 1 percent of GDP by 2025/26.

#### **Sensitivity analysis**

**For Ethiopia, the two most extreme stress tests involve (i) applying one half standard deviation shock to growth, exports and grants and (ii) new borrowing at less favorable rates.** Since Ethiopia has been accustomed to severe droughts over the past two decades, the standard deviation of output and export growth is high. Applying one half standard deviation shocks to growth, exports, and grants in 2006/07 and 2007/08 has a very important bearing on the debt profile since the ratio of debt to exports peaks at about 155 percent in 2010/11 and eventually levels out at 95 percent in 2025/26.

**While borrowing at less favorable rates raises the level of debt in relation to exports by about 50 percent, it does not lead to a breach in the debt threshold.** Over half of the new lending over the medium term is disbursed by the World Bank at an interest rate of 0.75 percent with a 10-year grace period and a 50-year repayment period. The stress test involving more expensive financing assumes that the average interest rate is higher by 2 percentage points for the whole forecast period. Since Ethiopia is expected to continue to borrow large amounts over the medium-term, this interest rate hike has significant adverse effects on the debt profile. However, the effects are much more gradual than for the scenario with shocks with the debt to export ratio peaking at 107 percent in 2018/19. Higher financing costs raise the debt-to-GDP ratio to peak at about 25 percent, and the debt service-to-export ratio levels out at 5 ½ percent. All these estimates are below the prudent thresholds.

**The debt profile is sensitive to assumptions made about export growth in the long run.** The baseline long-run forecast assumes that export growth levels out at about 11 ½ percent a



year. This estimate is comparable to the historical average for 1995–2005. However, it also implies a rising export share of output over time, since output in U.S. dollars is projected to grow at 8 percent a year. If the export ratio is projected to stabilize over the forecast period, this would have adverse effects on the debt to export ratio. Figure 2 presents the baseline projection and the profile of debt and debt service in relation to exports, assuming that exports in US dollars grow at the rate of output. In this case debt rises to about 100 percent of exports by 2025/26 in the sensitivity scenario, while debt service in relation to exports stabilizes at about 5 ½ percent a year. Though these figures are considerably higher than in the baseline scenario, they are still below the prudent thresholds.

**The inclusion of commercial loans to public enterprises has a sizeable effect on the DSA over the medium-term and is another justification for categorizing the debt risk as moderate.** The baseline scenario excludes commercial loans to public enterprises because they are not publicly guaranteed. This is one reason why Ethiopian Airline debt was not included in the ceiling of noncommercial debt in recent Fund-supported programs with Ethiopia. Ethiopian Airlines is currently financing 10 new Boeing 787 airplanes through 2012 at a cost of US\$1.2 billion and the Ethiopian electricity company also has ambitious investment plans. The Ethiopian telecom company is also investing up to US\$1.5 billion over the next 10 years. Incorporating these loans into the baseline (Figure 2), the NPV of debt to exports peaks at 140 percent in 2011/12 but then settles down to 60 percent over the long term. The debt service to exports ratio rises rapidly to peak at 14 percent within five years but then gradually falls toward the baseline estimate as the loans of the public enterprises are paid off. The stress tests also show considerably higher debt burden ratios when public enterprise debt is included, with breaches of all three indicative thresholds.

## I. FISCAL SUSTAINABILITY ANALYSIS

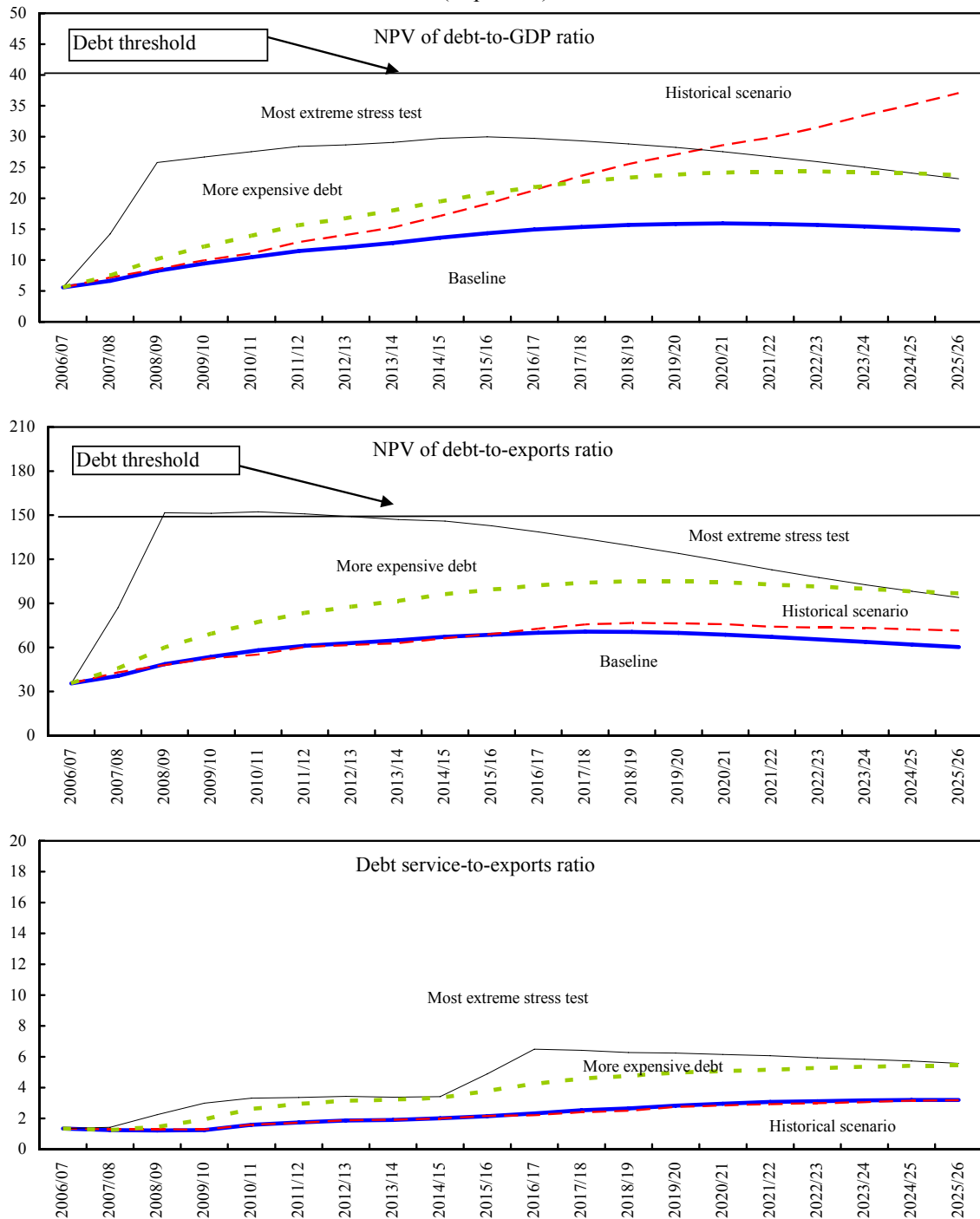
**The fiscal DSA is based on the assumption that annual domestic financing over the medium term will be around 2–2 ½ percent of GDP.** As a result, the ratio of total debt to GDP is projected to decline gradually from about 40 percent of GDP in 2005/06 to below 30 percent in the long run (Figure 3). This profile is slightly stronger than the corresponding scenario based on historical averages for the main macroeconomic determinants of public debt dynamics. One reason for the rapid decline in total debt over the medium term is that domestic interest rates rise only gradually to level out at 7 percent. If we assume a 3 percentage point increase in interest rates over the complete projection period, the ratio of total debt to GDP falls only modestly and stays at around 35 percent in the long run.

## II. CONCLUSION

**While external debt ratios have improved considerably with debt relief, the DSA shows a moderate risk of debt distress based on stress tests.** These stress tests capture the vulnerability of the Ethiopian economy to shocks and illustrate the importance of securing grant and concessional financing and containing domestic borrowing if debt is to stay

sustainable over the medium to long term. Also important are strengthened debt management capacity and a comprehensive public debt strategy that specifically includes public enterprise debt and contingent liabilities. Finally, the impact on debt ratios of new borrowing in infrastructure sectors underlines the need to ensure that these investments lead to sufficiently high returns.

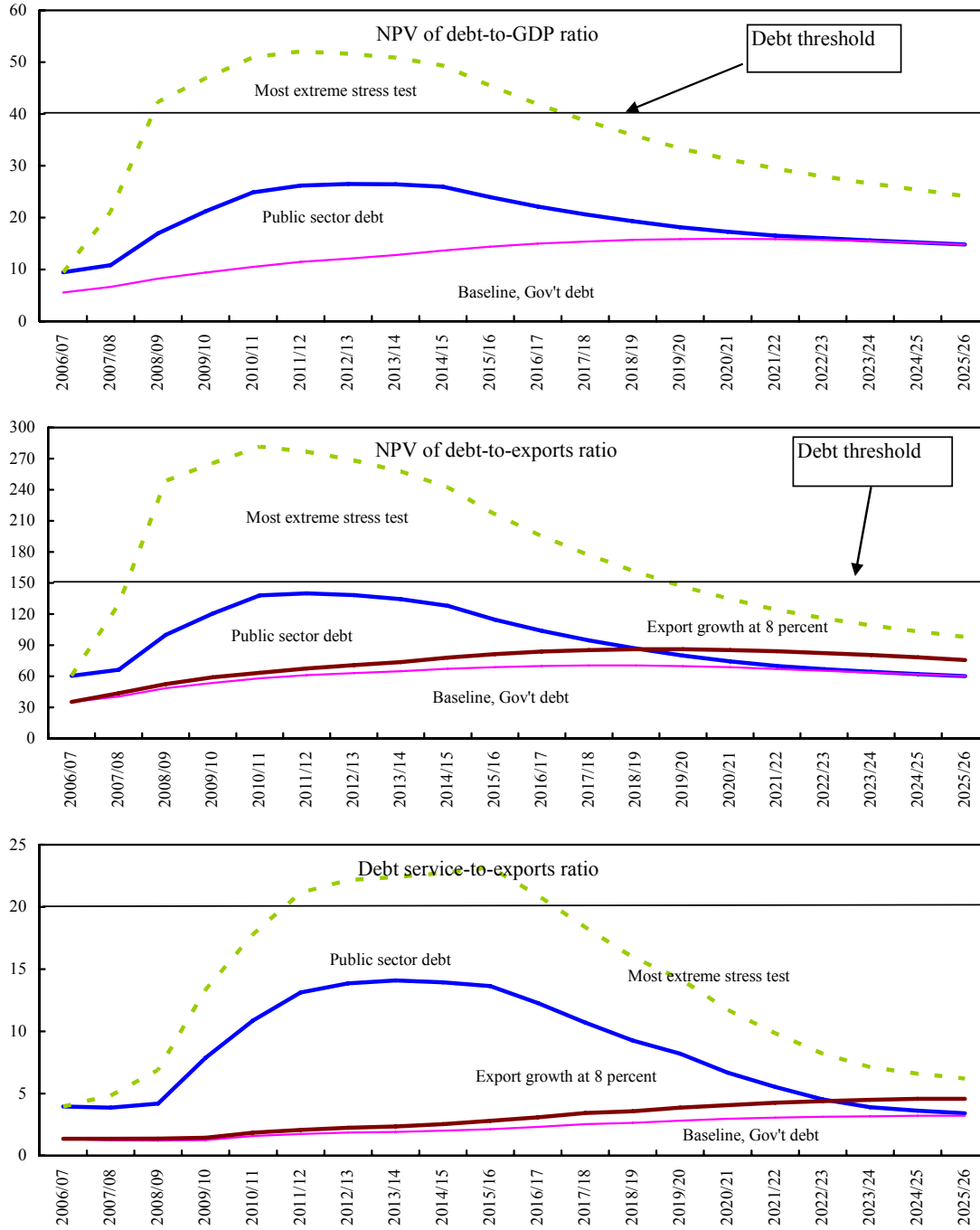
Figure 1. Ethiopia: Indicators of Public and Publicly Guaranteed External Debt Under Alternative Scenarios, 2006-2025, (In percent)



Source: Annex II, Tables 1 and 2.

Notes: The most extreme stress test involves one half standard deviation shocks to output and export growth and grants. In the debt service-to-exports panel, the debt service threshold is 20 percent

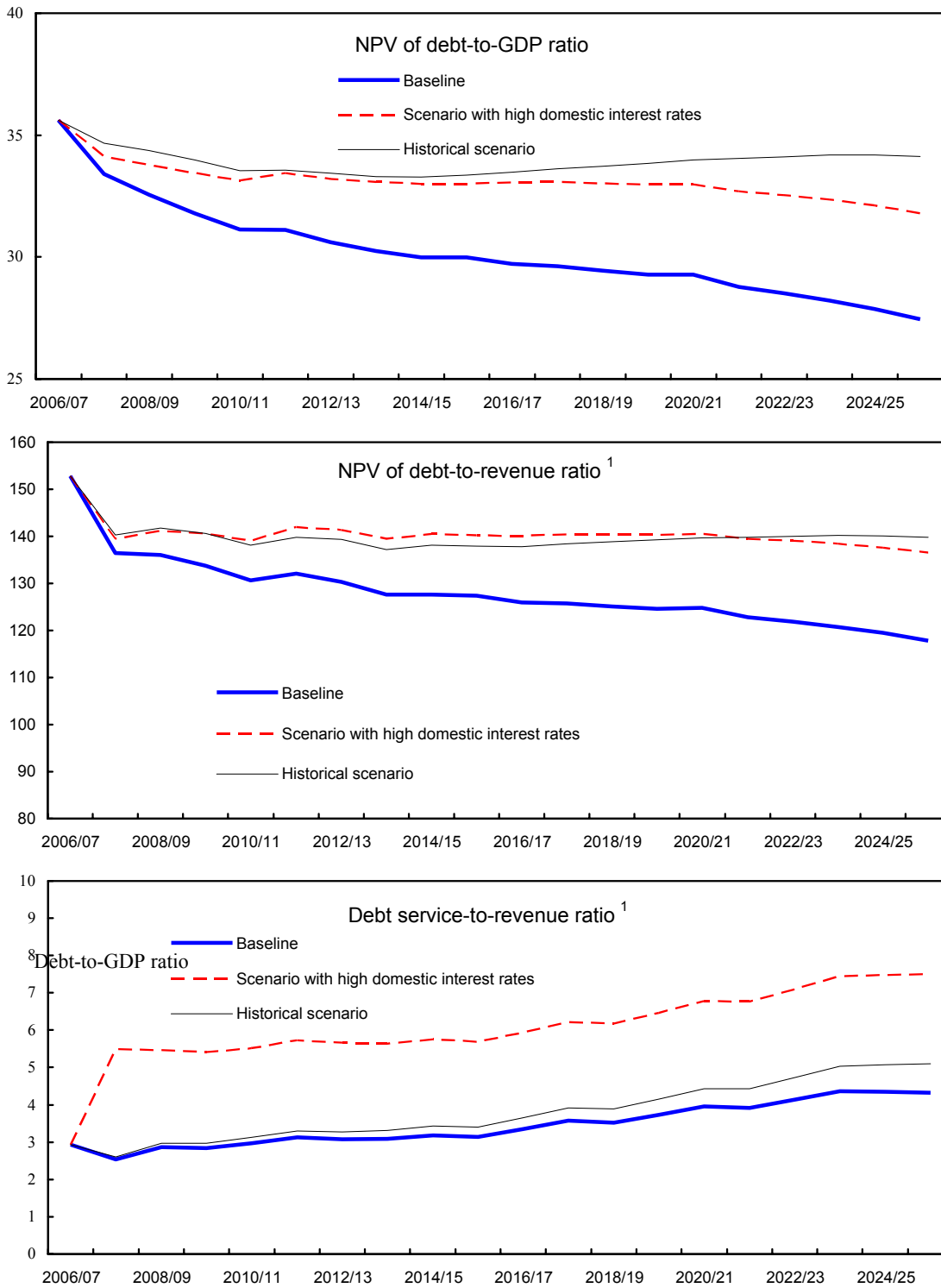
Figure 2. Ethiopia: Indicators of Public and Publicly Guaranteed External Debt Under Alternative Scenarios, 2006-2025, (In percent)



Source: Annex II, Tables 1 and 2.

Notes: In the debt service-to-exports panel, the debt service threshold is 20 percent

Figure 3. Indicators of Public Debt, 2005/06-2025/26



Source: IMF staff projections and simulations.  
<sup>1</sup> Revenue including grants.

Table 1. Ethiopia: External Debt Sustainability Framework, Baseline Scenario, 2006-2026 1/  
(In percent of GDP, unless otherwise indicated)

	Projections									
	2006/07	2007/08	2008/09	2009/10	2010/11	2015/16	2020/21	2025/26		
<b>External debt (nominal) 1/</b>	13.1	14.9	17.9	20.0	21.7	27.4	28.6	25.9		
o/w public and publicly guaranteed (PPG)	13.1	14.9	17.9	20.0	21.7	27.4	28.6	25.9		
Change in external debt	-31.7	1.8	3.0	2.1	1.7	1.0	-0.1	-0.7		
Identified net debt-creating flows	-0.9	0.1	1.7	0.5	0.5	-1.8	-2.6	-4.6		
<b>Non-interest current account deficit</b>	<b>5.5</b>	<b>3.7</b>	<b>5.1</b>	<b>4.1</b>	<b>4.2</b>	<b>2.4</b>	<b>1.9</b>	<b>-0.4</b>		
Deficit in balance of goods and services	22.6	21.7	22.3	21.7	22.1	19.2	19.1	17.1		
Exports	15.7	16.4	17.0	17.6	18.0	20.9	23.2	24.6		
Imports	38.3	38.1	39.3	39.3	40.2	40.1	42.3	41.7		
Net current transfers (negative = inflow)	-16.9	-17.9	-17.0	-17.6	-18.0	-16.8	-16.5	-16.5		
Other current account flows (negative = net inflow)	-0.2	-0.1	-0.1	0.0	0.1	0.1	-0.7	-1.0		
<b>Net FDI (negative = inflow)</b>	<b>-2.5</b>	<b>-2.5</b>	<b>-2.5</b>	<b>-2.5</b>	<b>-2.5</b>	<b>-2.8</b>	<b>-2.8</b>	<b>-2.8</b>		
<b>Endogenous debt dynamics 2/</b>	<b>-3.9</b>	<b>-1.0</b>	<b>-0.9</b>	<b>-1.1</b>	<b>-1.1</b>	<b>-1.4</b>	<b>-1.6</b>	<b>-1.5</b>		
Contribution from nominal interest rate	0.1	0.1	0.1	0.1	0.2	0.1	0.2	0.2		
Contribution from real GDP growth	-4.0	-1.1	-1.0	-1.2	-1.3	-1.6	-1.8	-1.7		
Contribution from price and exchange rate changes	...	...	...	...	...	...	...	...		
<b>Residual (3-4) 3/</b>	<b>-30.8</b>	<b>1.7</b>	<b>1.3</b>	<b>1.6</b>	<b>1.2</b>	<b>2.8</b>	<b>2.4</b>	<b>3.9</b>		
o/w exceptional financing	-0.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0		
NPV of external debt 4/	9.5	10.8	17.0	21.2	24.9	24.0	17.3	14.8		
In percent of exports	60.6	66.3	100.0	120.6	138.1	114.5	74.5	60.3		
<b>NPV of PPG external debt</b>	<b>5.6</b>	<b>6.6</b>	<b>8.3</b>	<b>9.4</b>	<b>10.5</b>	<b>14.4</b>	<b>15.9</b>	<b>14.8</b>		
In percent of exports	35.5	40.6	48.7	53.7	58.1	68.7	68.7	60.3		
Debt service-to-exports ratio (in percent)	1.4	1.2	1.2	1.3	1.6	2.1	3.0	3.2		
<b>PPG debt service-to-exports ratio (in percent)</b>	<b>1.4</b>	<b>1.2</b>	<b>1.2</b>	<b>1.3</b>	<b>1.6</b>	<b>2.1</b>	<b>3.0</b>	<b>3.2</b>		
Total gross financing need (billions of U.S. dollars)	0.5	0.2	0.5	0.4	0.4	0.0	-0.1	-1.7		
Non-interest current account deficit that stabilizes debt ratio	37.3	1.9	2.1	2.0	2.5	1.5	2.0	0.3		
<b>Key macroeconomic assumptions</b>										
Real GDP growth (in percent)	10.7	9.6	7.7	7.3	6.8	6.7	6.9	6.9		
GDP deflator in US dollar terms (change in percent)	7.9	2.3	1.9	1.1	0.5	1.1	1.1	1.5		
Effective interest rate (percent) 5/	0.3	0.9	0.9	0.8	0.9	0.8	0.8	0.8		
Growth of exports of G&S (US dollar terms, in percent)	18.3	17.1	13.8	12.4	10.0	11.2	10.4	9.0		
Growth of imports of G&S (US dollar terms, in percent)	9.7	11.6	13.0	8.6	9.7	8.1	9.0	7.0		
Grant element of new public sector borrowing (in percent)	53.4	50.8	52.3	53.4	52.5	50.7	51.6	52.4		
<b>Memorandum item:</b>										
Nominal GDP (billions of US dollars)	15.9	17.8	19.6	21.2	22.8	33.2	48.8	73.1		

Source: Staff simulations.

1/ Includes both public and private sector external debt.

2/ Derived as  $[r - g - r(1+g)] / (1+g+r)$  times previous period debt ratio, with  $r$  = nominal interest rate,  $g$  = real GDP growth rate, and  $r$  = growth rate of GDP deflator in U.S. dollar terms.

3/ Includes exceptional financing (i.e., changes in arrears and debt relief); changes in gross foreign assets; and valuation adjustments. For projections also includes contribution from price and exchange rate changes.

4/ Assumes that NPV of private sector debt is equivalent to its face value.

5/ Current-year interest payments divided by previous period debt stock.

6/ Historical averages and standard deviations are generally derived over the past 10 years, subject to data availability.

Table 2. Ethiopia: Sensitivity Analyses for Key Indicators of Public and Publicly Guaranteed External Debt, 2006-26  
(percent of GDP unless otherwise stated)

	Projections							
	2006/07	2007/08	2008/09	2009/10	2010/11	2015/16	2020/21	2025/26
<b>NPV of debt-to-GDP ratio</b>								
<b>Baseline</b>	5.6	6.6	8.3	9.4	10.5	14.4	15.9	14.8
<b>A. Alternative Scenarios</b>								
A1. Key variables at their historical averages in 2007-26 1/	5.6	7.1	8.5	9.9	11.0	19.0	28.6	37.2
A2. New public sector loans on less favorable terms in 2007-26 2/	5.6	7.6	10.3	12.4	14.1	21.1	24.7	24.3
<b>B. Bound Tests</b>								
B1. Real GDP growth at historical average minus one standard deviation in 2007-08	5.6	7.3	9.9	11.3	12.6	17.4	19.3	18.0
B2. Export value growth at historical average minus one standard deviation in 2007-08 3/	5.6	8.2	12.5	13.5	14.4	17.6	18.0	16.1
B3. US dollar GDP deflator at historical average minus one standard deviation in 2007-08	5.6	7.4	10.1	11.5	12.8	17.6	19.6	18.2
B4. Net non-debt creating flows at historical average minus one standard deviation in 2007-08 4/	5.6	13.0	20.3	21.0	21.8	23.8	22.0	18.5
B5. Combination of B1-B4 using one-half standard deviation shocks	5.6	14.4	26.3	27.2	28.1	30.5	28.0	23.5
B6. One-time 30 percent nominal depreciation relative to the baseline in 2007 5/	5.6	9.5	11.8	13.5	15.0	20.7	23.0	21.4
<b>NPV of debt-to-exports ratio</b>								
<b>Baseline</b>	35.5	40.6	48.7	53.7	58.1	68.7	68.7	60.3
<b>A. Alternative Scenarios</b>								
A1. Key variables at their historical averages in 2007-26 1/	35.1	42.2	47.2	51.7	54.2	68.2	74.8	70.9
A2. New public sector loans on less favorable terms in 2007-26 2/	35.9	46.6	60.9	70.4	78.5	101.1	106.6	98.8
<b>B. Bound Tests</b>								
B1. Real GDP growth at historical average minus one standard deviation in 2007-08	35.5	40.0	48.1	53.1	57.5	68.3	68.5	60.5
B2. Export value growth at historical average minus one standard deviation in 2007-08 3/	35.5	62.0	110.7	115.5	120.2	126.7	116.7	98.8
B3. US dollar GDP deflator at historical average minus one standard deviation in 2007-08	35.5	40.0	48.1	53.1	57.5	68.3	68.5	60.5
B4. Net non-debt creating flows at historical average minus one standard deviation in 2007-08 4/	35.5	78.0	117.1	117.0	118.0	111.1	92.7	74.0
B5. Combination of B1-B4 using one-half standard deviation shocks	35.5	88.3	154.5	154.1	155.1	145.1	120.3	95.6
B6. One-time 30 percent nominal depreciation relative to the baseline in 2007 5/	35.5	40.0	48.1	53.1	57.5	68.3	68.5	60.5
<b>Debt service ratio</b>								
<b>Baseline</b>	1.4	1.2	1.2	1.3	1.6	2.1	3.0	3.2
<b>A. Alternative Scenarios</b>								
A1. Key variables at their historical averages in 2007-26 1/	1.4	1.3	1.3	1.3	1.6	2.1	2.8	3.2
A2. New public sector loans on less favorable terms in 2007-26 2/	1.4	1.3	1.5	2.0	2.6	3.8	5.1	5.5
<b>B. Bound Tests</b>								
B1. Real GDP growth at historical average minus one standard deviation in 2007-08	1.4	1.2	1.2	1.2	1.6	2.1	2.9	3.2
B2. Export value growth at historical average minus one standard deviation in 2007-08 3/	1.4	1.6	2.1	2.5	3.0	4.0	5.5	5.5
B3. US dollar GDP deflator at historical average minus one standard deviation in 2007-08	1.4	1.2	1.2	1.2	1.6	2.1	2.9	3.2
B4. Net non-debt creating flows at historical average minus one standard deviation in 2007-08 4/	1.4	1.2	1.8	2.3	2.6	3.9	4.8	4.4
B5. Combination of B1-B4 using one-half standard deviation shocks	1.4	1.4	2.3	3.1	3.4	5.0	6.3	5.7
B6. One-time 30 percent nominal depreciation relative to the baseline in 2007 5/	1.4	1.2	1.2	1.2	1.6	2.1	2.9	3.2
<i>Memorandum item:</i>								
Grant element assumed on residual financing (i.e., financing required above baseline) 6/	51	51.3	51.3	51.3	51.3	51.3	51.3	51.3

Source: IMF staff projections and simulations.

1/ Variables include real GDP growth, growth of GDP deflator (in U.S. dollar terms), non-interest current account in percent of GDP, and non-debt creating flows.

2/ Assumes that the interest rate on new borrowing is by 2 percentage points higher than in the baseline., while grace and maturity periods are the same as in the baseline.

3/ Exports values are assumed to remain permanently at the lower level, but the current account as a share of GDP is assumed to return to its baseline level after the shock (implicitly assuming an offsetting adjustment in import levels).

4/ Includes official and private transfers and FDI.

5/ Depreciation is defined as percentage decline in dollar/local currency rate, such that it never exceeds 100 percent.

6/ Applies to all stress scenarios except for A2 (less favorable financing) in which the terms on all new financing are as specified in footnote 2.

Table 3. Country: Public Sector Debt Sustainability Framework, 2005/06-2025/26 (Baseline Scenario)  
(Percent of GDP, unless otherwise indicated)

	Projections								
	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	2015/16	2020/21	2025/26
<b>Public sector debt</b> <sup>1</sup>	43.2	41.7	42.3	42.4	42.4	43.0	42.8	42.2	38.6
<i>Of which</i> : foreign-currency denominated	13.1	15.0	18.0	20.1	21.8	23.4	26.5	28.8	25.9
Change in public sector debt	-36.7	-1.5	0.6	0.2	0.0	0.6	0.6	-0.3	-0.8
Identified debt-creating flows	-34.9	-3.0	-2.0	-1.5	-0.9	-0.4	-0.7	-0.6	-0.4
Primary deficit	3.6	3.2	3.3	3.2	3.1	3.3	2.9	2.7	2.5
Revenue and grants	23.3	24.5	23.9	23.8	23.8	23.6	23.5	23.5	23.3
<i>Of which</i> : grants	6.0	6.2	5.7	5.7	5.7	5.7	5.5	5.2	4.6
Primary (noninterest) expenditure	26.9	27.6	27.2	27.0	27.0	26.8	26.4	26.2	25.8
Automatic debt dynamics	-13.9	-6.1	-5.3	-4.7	-4.0	-3.7	-3.5	-3.3	-2.9
Contribution from interest rate/growth differential	-14.4	-7.0	-6.7	-6.4	-5.8	-5.5	-5.5	-5.4	-4.9
<i>Of which</i> : contribution from average real interest rate	-7.5	-3.6	-3.7	-3.5	-3.1	-3.0	-2.8	-2.7	-2.3
<i>Of which</i> : contribution from real GDP growth	-6.8	-3.4	-3.0	-2.9	-2.7	-2.5	-2.6	-2.7	-2.6
Contribution from real exchange rate depreciation	0.5	0.9	1.4	1.6	1.8	1.8	1.9	2.2	...
Other identified debt-creating flows	-24.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Debt relief (HIPC and other)	-24.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Residual, including asset changes	-1.8	1.5	2.5	1.6	0.9	1.0	1.3	0.3	-0.4
<b>NPV of public sector debt</b>	35.6	33.4	32.6	31.8	31.1	31.1	30.0	29.3	27.5
<i>Of which</i> : external	5.6	6.7	8.3	9.5	10.5	11.5	13.7	15.9	14.8
Gross financing need <sup>2</sup>	4.4	3.9	4.1	4.0	3.9	4.2	3.8	4.0	4.1
NPV of public sector debt-to-revenue ratio (percent) <sup>3</sup>	152.8	136.5	136.0	133.7	130.6	132.1	127.7	124.6	117.9
o/w external	23.9	27.2	34.5	39.8	44.0	48.7	58.1	67.6	63.7
Debt service-to-revenue ratio (percent) <sup>3,4</sup>	3.6	3.0	3.2	3.2	3.5	3.8	4.1	4.7	6.8
Primary deficit that stabilizes the debt-to-GDP ratio	40.3	4.7	2.7	3.1	3.1	2.7	2.3	3.0	3.3
<b>Key macroeconomic and fiscal assumptions</b>									
Real GDP growth (percent)	9.4	8.5	7.7	7.3	6.8	6.3	6.6	6.9	7.2
Average nominal interest rate on forex debt (percent)	1.0	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.9
Average real interest rate on domestic currency debt (percent)	-11.9	-8.9	-8.6	-7.7	-6.4	-6.0	-7.7	-5.4	-3.3
Inflation rate (GDP deflator, percent)	16.0	12.6	12.3	11.4	10.2	9.8	9.8	9.8	9.8
Growth of real primary spending (deflated by GDP deflator, percent)	20.5	12.9	6.1	6.3	6.4	5.6	5.4	6.6	7.0

Sources: Ethiopian authorities; and IMF staff estimates and projections.

<sup>1</sup> Covering public and publicly guaranteed debt on gross basis.

<sup>2</sup> Gross financing need is defined as the primary deficit plus debt service plus the stock of short-term debt at the end of the last period.

<sup>3</sup> Revenues including grants.

<sup>4</sup> Debt service is defined as the sum of interest and amortization of medium- and long-term debt.



Table 4. Country: Public Sector Debt Sustainability Framework, 2005/06-2025/26 (Alternative Scenario with High Interest Rates)  
(In percent of GDP, unless otherwise indicated)

	hide								
	Projections								
	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	2015/16	2020/21	2025/26
<b>Public sector debt</b> <sup>1</sup>	43.2	42.4	43.5	44.1	44.4	45.4	45.8	45.9	42.9
<i>Of which</i> : foreign-currency denominated	13.1	15.0	18.0	20.1	21.8	23.4	26.5	28.8	25.9
Change in public sector debt	-36.7	-0.8	1.1	0.6	0.4	1.0	0.8	-0.2	-0.7
Identified debt-creating flows	-34.9	-2.2	-1.5	-1.1	-0.5	-0.1	-0.5	-0.5	-0.3
Primary deficit	3.6	3.2	3.3	3.2	3.1	3.3	2.9	2.7	2.5
Revenue and grants	23.3	24.5	23.9	23.8	23.8	23.6	23.5	23.5	23.3
<i>Of which</i> : grants	6.0	6.2	5.7	5.7	5.7	5.7	5.5	5.2	4.6
Primary (noninterest) expenditure	26.9	27.6	27.2	27.0	27.0	26.8	26.4	26.2	25.8
Automatic debt dynamics	-13.9	-5.4	-4.8	-4.3	-3.6	-3.4	-3.3	-3.2	-2.8
Contribution from interest rate/growth differential	-14.4	-6.3	-6.2	-5.9	-5.4	-5.2	-5.3	-5.3	-4.8
<i>Of which</i> : contribution from average real interest rate	-7.5	-2.9	-3.1	-3.0	-2.6	-2.6	-2.5	-2.4	-1.9
<i>Of which</i> : contribution from real GDP growth	-6.8	-3.4	-3.0	-3.0	-2.8	-2.6	-2.8	-3.0	-2.9
Contribution from real exchange rate depreciation	0.5	0.9	1.4	1.6	1.8	1.8	1.9	2.2	...
Other identified debt-creating flows	-24.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Debt relief (HIPC and other)	-24.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Residual, including asset changes	-1.8	1.4	2.5	1.6	0.9	1.0	1.3	0.3	-0.4
<b>NPV of public sector debt</b>	35.6	34.1	33.8	33.4	33.1	33.5	33.0	33.0	31.8
<i>Of which</i> : external	5.6	6.7	8.3	9.5	10.5	11.5	13.7	15.9	14.8
Gross financing need <sup>2</sup>	4.4	4.6	4.7	4.6	4.6	4.8	4.4	4.6	4.9
NPV of public sector debt-to-revenue ratio (percent) <sup>3</sup>	152.8	139.4	141.1	140.6	139.0	142.0	140.5	140.3	136.5
o/w external	23.9	27.2	34.5	39.8	44.0	48.7	58.1	67.6	63.7
Debt service-to-revenue ratio (percent) <sup>3,4</sup>	3.6	5.9	5.8	5.7	6.1	6.4	6.7	7.0	10.0
Primary deficit that stabilizes the debt-to-GDP ratio	40.3	3.9	2.2	2.7	2.7	2.3	2.1	2.9	3.2
<b>Key macroeconomic and fiscal assumptions</b>									
Real GDP growth (percent)	9.4	8.5	7.7	7.3	6.8	6.3	6.6	6.9	7.2
Average nominal interest rate on forex debt (percent)	1.0	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.9
Average real interest rate on domestic currency debt (percent)	-9.3	-6.6	-6.2	-5.2	-3.8	-3.3	-5.2	-2.6	-0.4
Inflation rate (GDP deflator, percent)	16.0	12.6	12.3	11.4	10.2	9.8	9.8	9.8	9.8
Growth of real primary spending (deflated by GDP deflator, percent)	20.5	12.9	6.1	6.3	6.4	5.6	5.4	6.6	7.0

Sources: Ethiopian authorities; and IMF staff estimates and projections.

<sup>1</sup> Covering public and publicly guaranteed debt on gross basis.

<sup>2</sup> Gross financing need is defined as the primary deficit plus debt service plus the stock of short-term debt at the end of the last period.

<sup>3</sup> Revenues including grants.

<sup>4</sup> Debt service is defined as the sum of interest and amortization of medium- and long-term debt.





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June 15, 2007

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## **IMF Executive Board Concludes 2007 Article IV Consultation with The Federal Democratic Republic of Ethiopia**

On June 1, 2007, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with The Federal Democratic Republic of Ethiopia.<sup>19</sup>

### **Background**

Ethiopia's favorable economic performance in recent years has significantly contributed to poverty reduction and progress toward the Millennium Development Goals (MDGs). The economy has enjoyed a strong and steady growth in the past three years after a significant drought-related contraction in 2002/03. This strong growth performance resulted in real per capita income increasing at 7 percent per annum—the fastest in Ethiopia's recent history. However, this has been accompanied by rising inflation, with consumer price accelerating to 19 percent in February 2007.

Net domestic borrowing for budget financing rose to 3.1 percent of GDP in 2005/06 from 0.2 percent of GDP in 2003/04, reflecting declining domestic revenue effort and significantly reduced budget support from donors (a shortfall of 2 percentage points of GDP from what was budgeted) in view of political governance concerns following the 2005 election. Thus, despite efforts to reduce government expenditures by cutting large-scale infrastructure projects and constraining recurrent outlays, the overall budget deficit (including grants) remained large at about 4½ percent of GDP in 2004/05–2005/06.

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<sup>19</sup> Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. This PIN summarizes the views of the Executive Board as expressed during the June 1, 2007 Executive Board discussion based on the staff report.

Broad money growth remained fast in 2005/06, driven by credit expansion to both the government and nongovernment sectors. The demand for bank credit rose sharply to finance large-scale investment projects by the public enterprises and the rapidly expanding private sector. Substantial negative real interest rates and commercial banks' excess reserves facilitated the rapid expansion of credit.

Furthermore, current account deficit (after official grants) widened to 10½ percent of GDP in 2005/06, reflecting rising domestic demand. Although exports grew steadily, imports—particularly for raw material and capital goods—rose even faster, while donor assistance was reduced significantly. As a result, the overall balance of payments moved from a significant surplus in 2003/04 to a cumulative deficit equivalent to 2 percent of GDP during 2004/05–2005/06. Gross official international reserves declined from the equivalent of 3.7 months of imports at end-2003/04 to 2.1 months of imports at end-2005/06. The official exchange rate for the birr, however, remained relatively stable against the U.S. dollar (the intervention currency) at around birr 8.7 per U.S. dollar in 2005/06.

Strong economic growth is expected to continue in 2006/07. Real GDP growth is projected to hold at about 9½ percent as productivity gains in agriculture continue and nonagriculture activities, especially manufacturing and construction, expand further. Inflation is projected to decline to about 15 percent at the end of 2006/07, in light of the completion of the pass-through of fuel price increases and full adoption by farmers of the new pattern for food supply. After a period of relative stability, the depreciation of the birr against the U.S. dollar is expected to continue, reflecting the recent external balance developments.

### **Executive Board Assessment**

Executive Directors welcomed Ethiopia's recent strong and steady growth, which has also led to the fastest increase in real per capita incomes in recent years, and encouraging progress toward achieving the MDGs. At the same time, pressures on domestic prices and the balance of payments are emerging, the fiscal deficit remains large, and the economy continues to be vulnerable to weather-related shocks and shortfalls in donor support. Directors considered that, to further strengthen Ethiopia's growth prospects and to meet its poverty alleviation goals, structural reforms will need to be intensified in the period ahead. These should aim to eliminate infrastructural and administrative bottlenecks, and support the further development of the agricultural sector and the emergence of a robust and flexible private sector.

Directors welcomed the authorities' plans to adhere to a policy of fiscal restraint, as shown by the tightened 2006/07 budget and the intention to limit domestic borrowing. They supported the recent steps to enhance fiscal revenues, and encouraged the authorities to take further measures to restrain domestic demand, if required. Such measures could include stretching out expenditures on projects with a large import content and cutting low-priority outlays, while safeguarding poverty-reducing and growth-enhancing spending. Directors encouraged the authorities to strengthen debt management capacity and develop a comprehensive public debt strategy over the

medium term. In this regard, Directors suggested that the authorities avail themselves of Fund technical assistance.

Directors called for a tightening of monetary policy to reduce inflation and prevent the entrenchment of inflationary expectations. To help mop up excess reserves in the banking system, and pending the introduction of more sophisticated indirect monetary instruments, the authorities could consider testing the efficacy of issuing longer-term bonds. A gradual move to positive real interest rates would also help to contain inflationary pressures.

Directors welcomed the recent increase in exchange rate flexibility, and recommended that it be continued. This should allow the exchange rate to better reflect balance of payments developments and lay the groundwork for the needed buildup in international reserves. Directors cautioned that continued appreciation of the real exchange rate could weaken external competitiveness over the medium term, and encouraged the authorities to adopt productivity-enhancing structural reforms.

Directors observed that a critical challenge for Ethiopia is to accelerate structural reforms to buttress and sustain growth while maintaining macroeconomic stability. Emerging supply constraints need to be addressed expeditiously, and absorptive capacity expanded. Further efforts are needed to improve the investment climate, strengthen the financial sector, and promote trade openness. Directors encouraged the authorities to consider undertaking financial sector reforms within the framework of a developmental Financial Sector Assessment Program (FSAP).

Directors considered that data provided to the Fund are adequate for surveillance purposes, but that data shortcomings continue to complicate the analysis of economic developments, in particular with regard to the real sector and fiscal and balance of payments statistics. They called for further remedial efforts, and they supported the authorities' request for technical assistance from the Fund in this area.

**Public Information Notices (PINs)** form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.

**Table. Ethiopia: Selected Economic and Financial Indicators, 2003/04-2006/07 <sup>1</sup>**

	2003/04	2004/05	2005/06	2006/07
				Staff proj.
	(Annual percent change)			
National income and prices				
GDP at constant prices (at factor cost)	11.9	10.5	9.6	9.4
GDP deflator	4.2	9.6	7.4	16.0
Consumer prices (period average )	8.6	6.8	12.3	17.0
Consumer prices (end period)	1.7	13.0	11.6	15.2
External sector				
Exports, f.o.b.	24.4	41.1	18.1	9.9
Imports, c.i.f.	39.3	40.4	26.4	8.7
Export volume	28.0	21.1	5.0	10.6
Import volume	26.5	29.4	18.8	3.2
Terms of trade (deterioration – )	-14.6	8.0	5.1	-5.9
Nominal effective exchange rate (end of period)	-3.2	-1.5	-1.8	...
Real effective exchange rate (end of period)	-4.7	8.2	6.3	...
	(Percent of beginning-period stock of broad money, unless otherwise indicated)			
Money and credit				
Net foreign assets	8.9	-0.3	-1.6	9.0
Net domestic assets	2.0	19.9	19.0	20.8
Net claims on the government	7.1	9.3	7.1	7.9
Credit to the nongovernment sector	3.9	20.2	13.6	16.0
Broad money	10.9	19.6	17.4	29.7
Velocity (GDP/broad money)	2.42	2.43	2.43	2.39
Interest rates (Percent at end of period)				
Minimum savings deposit rates	3.0	3.0	3.0	...
Lending rates (average)	8.9	8.8	8.6	...
Treasury bill (91-day maturity)	0.5	0.1	0.0	...
Financial balances	(Percent of GDP, unless otherwise indicated)			
Gross domestic saving	5.4	2.6	5.2	8.1
Government saving	2.4	2.4	3.7	5.6
Private saving	3.0	0.2	1.5	2.4
Gross domestic investment	21.4	20.5	19.8	22.1
Government investment	9.0	9.1	8.4	10.1
Private investment	12.4	11.4	11.4	12.0
External current account balance, including official transfers	-4.2	-6.8	-10.4	-5.6
External current account balance, excluding official transfers	-10.2	-13.4	-16.9	-13.1
Government finances				
Revenue	17.0	15.8	16.9	17.3
Tax revenue	13.3	12.6	12.2	12.5
Nontax revenue	3.7	3.2	4.6	4.8
External grants	4.9	4.6	4.1	6.0
Expenditure and net lending <sup>2</sup>	25.1	25.2	25.4	27.6
Fiscal balance, including grants (cash basis)	-3.2	-4.7	-4.4	-4.3
Total financing	3.2	4.7	4.4	4.3
External financing	2.9	2.4	1.3	1.7
Domestic financing (including residual)	0.2	2.3	3.1	2.5
Public debt	113.6	87.1	79.8	43.2
Domestic debt <sup>3</sup>	35.8	34.2	35.0	30.1
External debt (including to Fund)	77.7	52.9	44.9	13.1
Net present value (NPV) of external debt-to-exports ratio (including to Fund) <sup>4</sup>	126.2	32.2	35.5	40.6
External debt-service ratio <sup>5</sup>	6.3	4.0	5.0	4.4
Overall balance of payments (Percent of GDP)	2.4	-0.9	-1.4	2.1
Gross official reserves (US\$ millions)	1,350	1,555	1,079	1,240
(months of imports of goods and nonfactor services of following year)	3.7	3.4	2.1	2.2
GDP at current market prices (Millions of birr)	81,755	98,398	115,589	146,970
Exchange rate (birr per U.S. dollar; period average rate)	8.62	8.65	8.68	...

Sources: Ethiopian authorities; and IMF staff estimates and projections.

<sup>1</sup> The fiscal year starts from July 8 to July 7.

<sup>2</sup> Including special programs.

<sup>3</sup> Whole series was revised.

<sup>4</sup> After enhanced HIPC relief. Exports of goods and services used.

<sup>5</sup> After enhanced HIPC relief.

**Statement by Peter Gakunu, Executive Director  
for The Federal Democratic Republic of Ethiopia  
and Joseph Tekman Kanu, Senior Advisor to Executive Director  
June 1, 2007**

1. The Ethiopian authorities acknowledge that the staff report provides a realistic view of the policy challenges facing them going forward. They consider the report to be broadly balanced and agree on the need to address the existing imbalances, especially those relevant to growth. In designing their policy response to address these imbalances, the authorities aim at reaching a policy mix that is adequate to preserve macroeconomic stability and sustain strong growth. They are of the view that the Article IV consultations provided an excellent opportunity to take stock of the progress made in recent years, especially under the PASDEP. They also agree that continued exchange of views on key policy issues is useful in supporting their ongoing efforts to boost Ethiopia's long-term growth prospects. Going forward, the major challenges facing the authorities include (i) addressing fiscal slippages (ii) tackling inflation and exchange rate, (iii) undertaking reforms to address structural bottlenecks affecting private sector-led growth, and (iv) external shocks including bad weather conditions.

**Recent Economic Developments**

2. Ethiopia's economy continues to enjoy a buoyant expansion after the drought related events of 2002/03. Real GDP grew by an annual average of 10.7 percent for the period 2003/04 through 2005/06, well above the 5.8 percent average for sub-Saharan Africa. Also, real per capita income increased during the period at an annual average of 7 percent. Growth remains broad based with manufacturing, construction, and services, all providing significant contributions. However, inflation has accelerated, reaching 19 percent in February 2007. The surge in food prices in particular, reflected an increase in disposable income and the reduced supply of cereals resulting from the shift from food to cash aid. However, the high food prices in the urban areas mainly impacted on the poor.

3. There were shortfalls in domestic revenue, including significant reductions in donor budgetary support, which resulted in an increase in net domestic borrowing to 3.1 percent of GDP in 2005/06. Consequently, a scaling down of expenditures from the original budget was undertaken by the authorities whereby large-scale infrastructure projects were postponed and restraints imposed on recurrent outlays. Despite these developments, the budget deficit remains large at about 4.5 percent of GDP a year for 2004/05–2005/06.

4. Broad money grew in 2005 and 2006 due to increased credit expansion to both government and the private sector. The increased demand for imports resulted in a widening of the external current account deficit to 10.5 percent of GDP in 2005/06. Although the capital account surplus doubled, the overall balance of payments experienced a rapid transition from the surplus in 2003/04 to a cumulative deficit equivalent to 2 percent of GDP for the periods 2004/05 and 2005/06. Subsequently, gross official international reserves declined from 3.7 months of imports at the end of 2003/04 to an equivalent of 2.1 months of

imports at the end of 2005/06. The local currency, the birr remained relatively stable despite the widening external imbalances and the real effective exchange rate appreciated by 6 percent in 2006.

### **Actions to Address Existing Macroeconomic Imbalances**

#### **(i) Fiscal Policy**

5. The Ethiopian authorities are determined to address the various macroeconomic imbalances impacting on the economy. In this regard, efforts are being made to ensure fiscal policy assists in containing pressures on prices and that international reserves are maintained at comfortable levels. The authorities will maintain the agreed level of domestic borrowing at between 2–2.5 percent in order to ensure achievement of the following objectives: (i) release resources to the private sector over the medium term, while ensuring a gradual decline in overall money growth to help contain inflationary pressures, (ii) contain demand pressures and mitigate impacts on the external position, and (iii) gradually reduce domestic debt and provide the needed flexibility to respond to shocks, particularly climatic shocks that may call for additional expenditures. While streamlining nonessential recurrent outlays, there will be adequate provision for operations and maintenance. Expenditures on capital goods will be reduced in the event of revenue shortfalls, while additional efforts will be undertaken to mobilize more domestic revenue.

#### **(ii) Monetary Policy**

6. Monetary policy will continue to support fiscal policy through introduction of more effective monetary instruments. In the absence of effective indirect instruments, the authorities have relied on direct instruments, which have not been relatively effective in curbing credit growth, given the excess reserves in the banking system. To ensure effectiveness in policy implementation, the authorities intend to concentrate more on indirect instruments especially over the medium term. In view of this, efforts are ongoing to develop an institutional framework for active open market operations; implementation of reforms in the financial sector to facilitate intermediation, strengthen risk-based management and supervision, and improve the environment for competition; and ensuring successful mopping up of excess cash reserves in the banking system through the sale of longer-term securities, facilitate the interbank market, and promote a more efficient and competitive financial sector.

7. Given concerns for inflation, particularly its impact on the urban poor and the low level of international reserves due to delayed disbursements of external assistance, the authorities intend to consolidate macroeconomic stability while maintaining growth momentum over the medium term. With the emerging positive indications that the external position will be strengthened in 2006/07, efforts will be directed at reducing the current account deficit by about half, to 5.6 percent of GDP. This will be supported by increased export growth, led by coffee and horticulture, combined with substantial increases in official transfers as relations with donors continue to normalize. As a result, the targeted overall balance of payments surplus of 2.1 percent of GDP will be achieved and will raise the level



of gross official international reserves to the equivalent of 2.2 months of imports by the end of 2006/07.

### **(iii) Exchange Rate Policy**

8. To strengthen monetary policy, the authorities' exchange rate policy will also continue to focus on achieving the inflation and international reserves targets. Inflation, which is currently at double digits, will be reduced to single digits. The authorities are however requesting further TA to help identify and address the factors contributing to the high inflation. They will continue to pursue prudent fiscal and monetary policies and a more flexible exchange rate. In addition, efforts will be directed at ensuring a gradual move to obtaining positive real interest rates. As a result, a cautious approach would be pursued in this direction in line with ongoing structural changes. This will help to significantly tighten monetary policy to keep high-inflation expectation from becoming entrenched. Going forward, the authorities are studying the possibilities of undertaking financial sector reforms within the framework of a developmental FSAP.

9. On the external front, the authorities have expressed their commitment to strengthen the reserves position by implementing measures such as issuance of directives to promote inward remittances and foreign currency deposits. Given that the current nominal exchange rate may not enhance growth over the medium term, the authorities are considering a reversal of the real appreciation achieved in recent years in an orderly and gradual manner. They will allow the exchange rate to depreciate more rapidly within the context of the de jure regime of a managed float.

### **The PASDEP Strategy**

10. To achieve the objectives of the MDGs, the authorities have continued with implementation of the PASDEP strategy which largely focuses on boosting economic activity through commercializing agriculture and fostering the nonfarm private sector. PASDEP policies will further concentrate on removing obstacles to growth, stimulating private sector development, and building the financial sector.

11. The authorities consider macroeconomic stability and debt sustainability as the major conduits for achieving strong and sustainable growth, given efforts to address the emerging supply constraints while expanding implementation and absorptive capacities. Major reforms will be undertaken to address constraints arising from access to land, the existing limited access to financing, in part caused by the limited capacity of domestic banks and the paucity of financial instruments; and the high transportation costs driven by the landlocked nature of the country. In addition, efforts will also be made to focus on improving the investment climate, strengthening the financial sector, and promoting trade openness.

12. Going forward, the authorities have identified major obstacles to private sector growth, in particular, the cumbersome licensing requirements, rigid labor market regulations, costly property registration, lengthy export and import procedures, and the high cost of enforcing contracts. To tackle these obstacles, they have introduced a one-stop-shop to

facilitate operations by new investors; established the Investors Advisory Council to allow regular consultations with the private sector; adopted an investment code that grants incentives; and have passed a business-friendly tax reform program.

13. The Ethiopian authorities will work towards mobilizing savings and allocating resources efficiently, given that a sound, dynamic, and competitive financial sector is essential to promote growth and reduce poverty. They will ensure that more action is taken to improve the quality of bank portfolios to enhance banking supervision and advocate risk-based management of credit. The authorities will also encourage increased competition in the banking sector to improve the efficiency of monetary policy.

## **Conclusion**

14. Prospects for the medium-term economic outlook for Ethiopia remain highly favorable, with real GDP growth expected to average 7.5 percent a year for the period 2007/08– 2010/11. To achieve this, the authorities intend to reinforce the foundations for growth, achievement of the MDGs and meeting PASDEP targets, underpinned by their strategy of consolidating macroeconomic stability.

15. The authorities are aware of the challenges ahead and are ready to strike a judicious balance between demand-dampening measures and growth-enhancing structural economic reforms. Additional efforts will be made to intensify policy implementation over the medium term in order to contain any pressures on prices and the balance of payments. This will place inflation on check and maintain the intended level of international reserves.

16. To ensure debt sustainability over the medium term, the authorities will continue to secure grant and concessional financing and limit domestic borrowing. They are already preparing a comprehensive public debt management strategy that will also include public enterprises debt and contingent liabilities, and will strengthen their current debt management capacity.

17. Given the importance of data in ensuring effective analysis of economic developments, the authorities are committed to improving the quality of data, and are therefore, requesting technical assistance from donors and the Fund. They also intend to address the high turnover of relevant staff, define priorities, and improve inter-agency coordination in order to ensure sustainability of statistical reforms.

18. The Ethiopian authorities continue to express their commitment to remain engaged with the Fund. They are of the view that one critical issue to achieving the Millennium Development Goals (MDGs) is the need for scaling up of financing. The authorities therefore call on the Fund to provide the needed signals for full donor participation in their macroeconomic stabilization and growth drive. Once this is achieved, sustaining the current growth trajectory is of crucial importance for which considerable Fund support is required.