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Ethiopia: 2002 Article IV Consultation and Third Review Under the Poverty Reduction and Growth Facility Arrangement—Staff Report; Staff Statement; and Public Information Notice and News Brief on the Executive Board Discussion

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 Article IV consultation with Ethiopia, the following documents have been released and are included in this package:

- the staff report for the 2002 Article IV consultation and third review under the Poverty Reduction and Growth Facility arrangement, prepared by a staff team of the IMF, following discussions that ended on **July 15, 2002,** with the officials of Ethiopia on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on August 20, 2002.** 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 statement of **September 23, 2002** updating information on recent developments.

- a Public Information Notice (PIN) and a News Brief summarizing the **views of the Executive Board as expressed during its September 23, 2002 discussion** of the staff report that concluded the Article IV consultation.

The document(s) listed below have been or will be separately released.

Joint Staff Assessment of the Poverty Reduction Strategy Paper
Letter of Intent*
Poverty Reduction Strategy Paper
Statistical Appendix

*May also be included in Staff Report

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

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ETHIOPIA

Staff Report for the 2002 Article IV Consultation and Third Review Under the Poverty Reduction and Growth Facility Arrangement

Prepared by the African Department

(In consultation with the Fiscal Affairs, Legal, Monetary and Exchange Affairs, Policy Development and Review, Statistics, and Treasurer's Departments)

Approved by José Fajgenbaum and G. Russell Kincaid

August 20, 2002

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EXECUTIVE SUMMARY

Recent Economic Developments

- Since 2000, the authorities have been implementing wide-ranging structural reforms and pursuing prudent macroeconomic policies supported by the PRGF arrangement. However, with per capita income still about US$100, Ethiopia remains one of the poorest countries in the World and continues to face major challenges.

- **Performance under the first annual PRGF-supported program (October 2000-September 2001) was good, and the second annual program remains on track in the context of Ethiopia's steady progress toward peace with Eritrea.** Real GDP growth for 2001/02 is estimated to have decelerated to 5 percent, while inflation remained negative, reflecting continued food surplus. The external current account deficit (including official transfers) widened to 6.6 percent of GDP in 2001/02 from 4.2 percent in 2000/01. All the quantitative and structural performance criteria and benchmarks for December 2001 and March 2002 were met, with the exception of the revised regulation for the provisioning by banks for nonperforming loans, which was adopted, but was not fully in line with international best practice, as had been envisaged.

- **The fiscal deficit (including grants and special programs)** increased considerably in 2001/02, as a result of the accelerated implementation of special programs and capital and poverty-targeted expenditure, which reached 16.7 percent of GDP. Several tax policy measures were implemented. Defense outlays were cut to 5.9 percent of GDP. Broad money for the first nine months of 2001/02 increased by less than programmed. Several measures were taken to improve the soundness of the financial sector. The wholesale foreign exchange auction began to operate more efficiently and was replaced by an interbank foreign exchange market in October 2001. **The exchange rate regime and policy remain adequate.**

Ethiopia: Selected Economic and Financial Indicators, 2000/01-2004/05 1/

	2000/01	2001/02		2002/03		2003/04	2004/05
	Estimate	EBS/02/37	Estimate	EBS/02/37	Rev. Prog.	Revised Projections	
	(Annual percentage change)						
Real GDP	7.7	5.8	5.0	6.0	6.0	6.0	6.0
Inflation (period average)	-7.2	3.0	-7.2	3.0	4.5	3.0	3.0
Money supply (M3)	9.5	11.1	10.9	9.9	12.4	10.0	...
	(In percent of GDP)						
Fiscal balance (incl. grants, excluding special programs)	-5.0	-6.9	-7.9	-5.9	-8.0	-5.0	-4.7
Special (post-conflict) programs	0.8	2.2	2.0	1.9	1.7	1.4	0.0
External current account balance (incl. official transfers)	-4.2	-7.1	-6.6	-6.2	-6.9	-5.4	-4.0
	(In months of imports)						
Gross official reserves	2.0	2.9	3.9	3.8	4.3	4.4	4.5

Sources: Ethiopian authorities; and staff estimates and projections.

1/ Year ending July 7.

Policies for the remainder of the second annual program and prospects for 2002/03

- Under the updated macroeconomic framework, real GDP growth is projected at 6 percent in 2002/03. As food supply returns to a more normal level, average consumer price inflation is expected to rise to 4.5 percent. The external current account deficit is projected to increase to 6.9 percent of GDP in 2002/03, as official transfers would decline to a more normal level.

- **In the fiscal area,** the overall deficit (including grants and special programs) is to be limited to 9.7 percent of GDP in 2002/03. The authorities are pursuing their tax reforms with the recent strengthening of the large taxpayer unit and the introduction of the value added tax in January 2003. On the spending side, a cautious stance will be pursued, with defense spending maintained at the nominal level of the previous year, while poverty-targeted outlays will be increased. Progress is being made in improving the planning, tracking, and reporting of public expenditure.

- In the **monetary and exchange areas,** monetary policy will remain geared toward achieving the inflation and international reserve targets. Further reforms are to be implemented to strengthen the financial sector and improve its competitiveness, including the revision of the new regulation for the provisioning of nonperforming loans, to bring it more in line with international best practice, and the signing of a performance contract between the government and the new management of the Commercial Bank of Ethiopia (CBE), with a view to operating it on a commercial basis. A financial audit of the CBE will be conducted by an internationally reputable firm. A workshop was held with Fund and World Bank staffs and guest speakers from neighboring countries to discuss the competitiveness of the financial sector, and the role of entry of foreign banks in the sector. However, the authorities were not ready at this stage to take this measure.

- On **other structural reforms**, the authorities, with the support of the World Bank, are implementing reforms in the areas of agriculture, private sector development, export promotion, the civil service, and public expenditure management and control.

Issues stressed in the staff appraisal

- **The authorities need to continue to implement the PRGF-supported program effectively**, and to guard against slippages during the program period.

- **It is important to persevere with a prudent expenditure policy, to limit the recourse to bank financing**, and to implement steadfastly tax reforms so as to achieve the revenue target. To avoid risking macroeconomic stability and debt sustainability, the macroeconomic framework described in the PRSP for 2003/04-2004/05 will need to be carefully assessed once additional external financing is identified.

- **The reforms agreed upon to strengthen the financial sector and improve its competitiveness need to be pursued vigorously.** In particular, the authorities should continue their efforts to address the difficulties of the CBE, including carrying out an audit by an internationally reputable firm. It is regrettable that the authorities decided not to allow at this stage foreign bank entry in the financial sector to enhance competition.

- **The agenda of other structural reforms should be adhered to. The finalization of the full PRSP** is welcome, after full participation by civil society and development partners.

I. Introduction

1. Discussions for the 2002 Article IV consultation and the third review under the three-year arrangement under the Poverty Reduction and Growth Facility (PRGF) took place in Addis Ababa during May 6-24, 2002 and were concluded in Washington during July 8-12, 2002.[1] The staff team also discussed, jointly with World Bank staff, the full poverty reduction strategy paper (PRSP), which, together with a joint staff assessment, will be issued shortly. The attached letter from the Minister of Finance and Economic Development of Ethiopia and the Governor of the National Bank of Ethiopia (NBE), dated August 19, 2002 (Appendix I), reviews recent economic developments and progress made during the first nine months of 2001/02, and sets out the policies and measures to be implemented by the government during the remainder of the second annual program supported by the PRGF arrangement.

2. The PRGF arrangement, in an amount of SDR 86.91 million (65 percent of quota), was approved on March 22, 2001 (EBS/01/6, 1/30/01; and EBS/01/113, 2/5/01). On the occasion of the second review on March 18, 2002, this amount was augmented by SDR 13.37 million (10 percent of quota) to mitigate the impact on the balance of payments of the continued deterioration of the terms of trade and the events of September 11, 2001 (EBS/02/37, 3/4/02). Availability of the fourth disbursement (SDR 10.43 million) is contingent on the completion of the third review, including observance of end-March 2002 performance criteria.[2]

3. In concluding the last Article IV consultation in March 2001 and the first and second reviews under the PRGF arrangement, Executive Directors commended the authorities for Ethiopia's good economic performance under the PRGF-supported program. They stressed the importance of further fiscal consolidation, including the continued reorientation of budgetary resources from defense toward poverty alleviation and the speeding up of the

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[1] The Ethiopian representatives included Mr. Sufian Ahmed, Minister of Finance and Economic Development; Mr. Teklewold Atnafu, Governor of the National Bank of Ethiopia; Mr. Newai Gebre-ab, Chief Economic Advisor to the Prime Minister; other ministers in charge of economic and social affairs; and other senior government officials. The mission also met with the Prime Minister, Mr. Meles Zenawi; as well as parliamentarians, and representatives of the private sector, bankers, nongovernmental organizations, and donors. The staff team consisted of Mr. Tahari (head), Mr. Kyei (the Fund's Resident Representative), Mr. Guillaume, Ms. Strauss, and Mr. Bhavnani (Research Assistant) (all AFR), Mr. Kapteyn (PDR), and Mrs. Vibar (Administrative Assistant-AFR).

[2] Ethiopia's outstanding use of Fund resources amounted to SDR 101.4 million (75.8 percent of quota) on June 30, 2002. If the planned disbursements under the PRGF arrangement and all loan repayments are made as scheduled, Ethiopia's use of Fund resources would amount to SDR 122.3 million (91.5 percent of quota) at end-June 2004 (Tables 1 and 2).

implementation of tax reforms. Executive Directors emphasized the need to improve the soundness and competitiveness of the financial sector, including by removing barriers to foreign bank entry.

4. The Executive Boards of IDA and the Fund decided on November 6 and 8, 2001, respectively, that Ethiopia was eligible for concessional assistance and had reached the decision point under the enhanced Initiative for Heavily Indebted Poor Countries (HIPC Initiative) (EBS/01/174, 10/16/01). The World Bank is supporting Ethiopia's reconstruction and reform efforts through emergency programs (US$428 million over three years) approved in December 2000, an Economic Rehabilitation Support Credit (ERSC—for US$150 million) approved in June 2001, and a new Economic and Structural Adjustment Credit (ESAC—US$120 million) approved in June 2002 (Appendix III).

II. Recent Developments and Performance Under the Program

5. **Performance under the first annual program (October 2000-September 2001) was good, and the second annual program remains on track.** Real GDP growth in 2000/01 (fiscal year ended July 7) is estimated to have been about 7.7 percent, consumer price inflation turned negative, reflecting a bumper cereal crop, and the external current account deficit (including official transfers) fell to 4.2 percent of GDP from 5.3 percent in 1999/2000.[3] Coffee exports (which account for 40 percent of merchandise exports) were lower than expected, as both volume and prices fell. With a slower-than-anticipated pace of project implementation, imports were also lower than expected.

6. The second annual program, straddling the fiscal years 2001/02 and 2002/03, (a) assumed average rates of real GDP growth of 6 percent; (b) aimed at limiting consumer price inflation to 3 percent; and (c) sought to increase the reserve cover from 2 months of the following year's imports as of July 2001 to 2.9 months by July 2002, and further to 3.8 months by July 2003.

7. **All the quantitative performance criteria and benchmarks for December 2001 and March 2002 were met (Appendix I, Table 1). Structural performance criteria and benchmarks through March 2002 have also been observed with one exception:** The revised regulation for the provisioning by banks for nonperforming loans and other doubtful assets (benchmark) was adopted but was not fully in line with international best practice, as had been envisaged (Appendix I, Table 2). The regulation is to be revised by August 31, 2002, as a prior action.

8. As prices of coffee and cereals continued to fall in 2001/02 and credit to the economy declined, economic activity grew more slowly than anticipated, and real GDP growth is estimated to have decelerated to 5 percent in 2001/02 (Table 3 and Figure 1). Following the 2000/01 bumper crop, agricultural output is estimated to rise by 4.5 percent in 2001/02,

[3] For more details, see EBS/01/108 (7/5/01) and EBS/02/37 (3/4/02).

lower than initially projected. Nonagricultural GDP however, is still estimated to grow by about 5.5 percent. Total export earnings are in line with projections, as the fall in coffee export prices was offset by higher volume. With much higher food imports, total imports are slightly higher than projected. Consumer price inflation remained negative in the first nine months of 2001/02, reflecting continued food surplus, as discussed in Box 1.

9. Under the second annual program, the fiscal deficit (including grants and special programs) was budgeted to increase from 5.7 percent of GDP in 2000/01 to 9.1 percent in 2001/02 (Tables 4 and 5) as a result of the accelerated implementation of special programs and capital and poverty-targeted expenditure. Fiscal performance during the first nine months of 2001/02 was consistent with the program. Several tax measures were implemented, the large taxpayer unit and tax reform implementation task force established in 2001 have been strengthened, and draft legislation for the introduction of a value-added tax (VAT) was submitted to parliament on October 1, 2001 (performance criterion) and was passed in early July 2002.[4] Total government revenues for the first nine months of the year were slightly lower than projected, due to lower direct and indirect tax revenue. Government expenditures were also slightly lower than programmed, reflecting cautious budgetary management and delays in the disbursement of program aid.[5] The authorities slowed defense expenditure, and social spending was in line with program projections.

10. **In the monetary area,** reflecting lower-than-projected economic activity and negative inflation, broad money for the first nine months of 2001/02 grew by 5.3 percent, compared to 10.9 percent under the program. Total bank credit fell by 2.3 percent for the first nine months of 2001/02, compared to an increase of 6.3 percent in the program, and net bank credit to the government declined by 2.9 percent, compared to a rise of 2.6 percent under the program. Increased auctions of government securities reduced excess reserves of commercial banks to 3.4 percent of deposits in December 2001, down from 5.3 percent in July 2001. However, higher deposits with lower credit had led to a rise in excess reserves to 6.9 percent of deposits by March 2002. Reflecting the National Bank of Ethiopia's (NBE) efforts to mop up liquidity, commercial banks increased their holdings of Treasury bills in the last quarter of 2001/02. Depressed coffee prices have also contributed to a rise in nonperforming loans in the coffee sector.[6] In response to the subdued economic activity and low inflation, the NBE lowered the floor on savings deposit rates from 6 percent to 3 percent on March 4, 2002. All banks have adjusted their deposit and lending interest rates in line with this reduction.

[4] Over the last two years the tax to GDP ratio rose by 3.7 percentage points to 16.2 percent in 2001/02, reflecting the impact of the tax measures implemented, while nominal GDP declined slightly because of negative inflation.

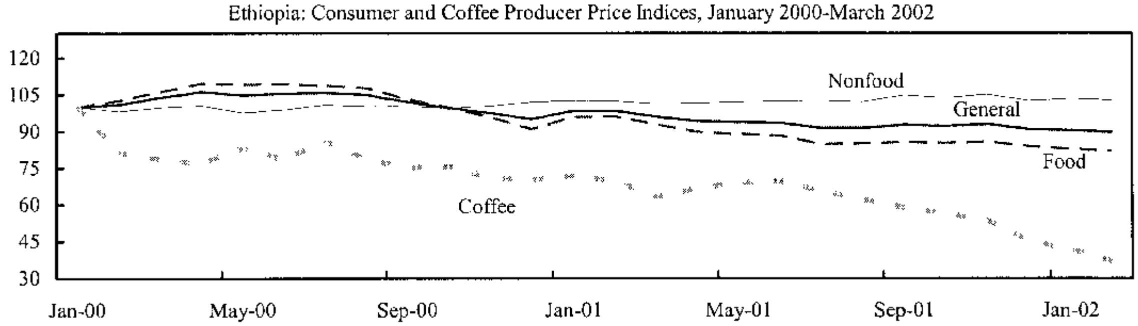
[5] The delays were mainly due to administrative reasons.

[6] Nonperforming loans to the coffee sector are estimated at about 5 percent of total loans, out of a total of nonperforming loans of 31 percent.

Box 1. Ethiopia: Cereal and Coffee Producer Price Declines and Authorities' Response

Annual average inflation was –7.2 percent in 2000/01 and –9.2 percent in the first nine months of 2001/02. This was driven by negative food inflation (-16 percent in March 2002) in urban and rural areas, which was mainly caused by a precipitous decline in cereal prices (-22.2 percent in the first nine months of 2001/02). Also, producer prices for coffee fell by 44.6 percent in the first nine months of 2001/02, reflecting global price developments. The authorities are greatly concerned by the impact of these developments on poor producers.

Ethiopia: Consumer and Coffee Producer Price Indices, January 2000-March 2002



Producer prices of food have fallen due to oversupply mainly caused by (a) the bumper crop in 2000/01 (agricultural production expanded by 19.4 percent); and (b) unprecedented food aid and commercial imports in the first 9 months of 2001/02 (US$140 million—nearly double the value of food imported in 2000/01). The previous buildup of large food stocks, limited export potential owing to good harvests in Kenya and Sudan in 2001/02, prohibitive transport costs, and low purchasing power in food deficit areas have prevented higher cereal prices. Despite record levels of production and low food prices, Ethiopia will require food aid in the foreseeable future in food-deficit regions, as transport from food-surplus to food-deficit regions remain very costly or not possible, and to help the needy (a population of about 5 million).

To reverse the decline in food prices while meeting Ethiopia's food aid requirements, the authorities are urging donors to increase domestic purchases of food aid from food surplus regions. Of the approximately 490,000 metric tons of cereals that are available locally for food aid purchases in 2002, donors planned as of late-February 2002 to purchase 200,000 metric tons. Small-scale local food aid purchases in 2001 failed to prop up prices. Other measures considered include the selective use of cash-based public works programs to increase demand for cereals, and steps to ease credit availability for grain traders.

In response to the precipitous decline in coffee export prices, the authorities have (a) suspended the 6 percent coffee export tax for exports below a threshold price; (b) suspended the 5 percent withholding income tax on export proceeds; and (c) eased restrictions on the domestic sale and intraregional transfer of coffee. Additionally, banks have been refinancing supplier and exporter loans as needed. The authorities are also preparing for the certification of organically grown Ethiopian coffee, and are considering establishing a commodity exchange.[1]

In the medium term, the authorities are taking steps to prop up rural incomes, including measures to encourage crop diversification; ensure that farmer's production decisions are market driven through better price transmissions; and enhance rural transport. The authorities intend to conduct a study to identify ways to mitigate the impact of the decline in coffee and cereal producer prices.

[1]For further information on developments and outlook for the coffee sector, see Box 1 of EBS/02/37 (3/4/02).

11. **Several measures were taken to improve the soundness and competitiveness of the financial sector**, including the issuance of government guarantees for assets held in Eritrea, the issuance of a letter to encourage public entities to do business with all banks, the establishment of a bankers' association, and the lifting of restrictions on the payment of interest on current account deposits. A comprehensive study of the NBE's operational, organizational, and administrative setup is being finalized. With respect to the Commercial Bank of Ethiopia (CBE), which still has over 80 percent of bank deposits and about 70 percent of bank loans, its board was reconstituted to increase private sector participation. The management contract for the CBE with a foreign bank did not enter into effect as the foreign bank withdrew from the contract in January 2002. At the same time, the Ethiopian anticorruption commission arrested 28 past and 13 current CBE officials on charges of corruption. Against this background, in March 2002 the authorities appointed a new management team that will operate CBE on a commercial basis. Moreover, lending by CBE to customers with loans past due by over one year has been interrupted.

12. A workshop was held in Addis Ababa during April 3-4, 2002 to discuss the role of the financial sector in economic development and the issue of competition in the sector, including possible foreign bank entry or breaking up or privatizing CBE. The authorities welcomed the workshop, but, contrary to the views expressed by the guest speakers from neighboring countries and Fund staff, they indicated that they were still concerned about allowing foreign bank entry at this stage because of uncertainties about its impact on the domestic interest and exchange rates, and the possible dominance of the sector by foreign banks (Box 2).

13. **Considerable progress in liberalizing the foreign exchange market has been made in recent months.** Restrictions on the purchase of foreign exchange for holiday travel and education purposes were eliminated in March 2001. The wholesale foreign exchange auction was replaced by an interbank foreign exchange market in October 2001. The birr depreciated by 1.1 percent against the U.S. dollar and by 3 percent in real effective terms during the first nine months of the fiscal year (Figure 2). At end-March 2002, net foreign assets of the NBE were estimated at US$319 million (about 1.8 months of import cover) compared with the US$282 million programmed.

14. As recommended by the recent **safeguards assessment of the NBE**, the Audit Services Corporation submitted to the NBE's board an unqualified audit of NBE's financial statements by end-March 2002 (performance criterion). All differences older than six months on correspondent accounts are being reconciled, and steps are being taken to ensure that the NBE's accounting records properly reflect the balances held with foreign correspondent banks.

Box 2. Ethiopia: The Issue of Competition in the Financial Sector

There have been differences of views between the Ethiopian authorities and the staff on how best to enhance competition in the financial sector. The staff and the authorities agree that a sound and efficient financial sector is key to supporting economic growth and reducing poverty. However, while the staff considers that competition should be fostered through allowing entry of reputable foreign banks or privatizing or breaking up the Commercial Bank of Ethiopia (CBE), the authorities believe that it is important to first strengthen the financial sector and enhance the supervisory capacity of the central bank. The staff agrees that these steps should be undertaken urgently.

At the request of the Ethiopian authorities, the Fund organized in April 2002 a workshop on "The Development of the Financial Sector in Ethiopia: the Issue of Competition." The highlight of the workshop was the presentations made by representatives from Kenya, Tanzania, and Uganda. All three speakers noted that after a transition period the liberalization of the financial sector brought competition, stronger capitalization of the banking sector, more diversified lending, and more efficient financial intermediation. In these countries, foreign entry of reputable banks has been successful and has provided the financial sector with a strong capital base, skills, and technology. All three speakers and the Fund staff urged the Ethiopian authorities not to delay the liberalization of the financial sector and to allow foreign bank entry. They noted the importance of a quick privatization process for a large state-owned bank to mitigate political interference, and the success of refocusing banking activities into separate entities centered on rural financing and commercial banking.

The authorities, however, indicated that they were still concerned about allowing foreign bank entry at this stage because of uncertainties about the possible impact on the domestic interest and exchange rates, and the possible dominance of the sector by foreign banks. They wished first to prepare the ground for the progressive integration of the Ethiopian financial sector into the global financial market by improving the environment for banks. They wanted to strengthen private and public banks by creating a favorable external environment for banking, strengthening the internal dynamics of banks, and fostering contestability of markets within the banking sector. To that end, the authorities noted that measures were taken to enforce the foreclosure law effectively and expeditiously to allow banks to reduce nonperforming loans and deter delinquency in loan repayments. Banks will be encouraged to modernize and raise efficiency by adopting improved practices and building their capacities through a rigorous application of the revised bank provisioning directive, as well as more autonomous bank management that will be made more accountable to their boards of directors. To enhance competition, private banks will be encouraged to increase their scale of operation and raise their capital base, including through mergers.

As discussed during the workshop, staff believes, however, that the measures proposed by the authorities will not be sufficient to increase the efficiency of the financial sector, given the continued dominant position of the CBE. Therefore, staff continues to urge the authorities to keep all options open to enhance competition in the financial sector.

15. In other **structural areas**, progress was made with World Bank assistance, in implementing reforms focused on public sector management, including the civil service and public expenditure policy, and on private sector development. Revised investment and urban land lease laws were adopted. However, implementation of the privatization program slowed because the sale of the larger companies, including industrial enterprises, faced a more limited set of potential buyers.

16. **Further progress was made toward restoring peaceful conditions between Ethiopia and Eritrea**. To date, Ethiopia has demobilized 140,000 soldiers (or about 39 percent of the armed forces). An international boundary commission delivered its final and binding ruling on the border between Eritrea and Ethiopia on April 13, 2002, and both countries accepted it.

III. Report on the Discussions

17. The discussions with the authorities focused on the medium-term policy framework, including the policies needed to achieve the growth and poverty reduction objectives, as well as on (a) reviewing program implementation; (b) updating the macroeconomic framework and seeking understandings on the 2002/03 budget; (c) reaching understandings on measures to strengthen the financial situation of the CBE; and (d) establishing quantitative and structural performance criteria and benchmarks through December 2002.

A. Overview of Key Challenges and Medium-Term Economic Strategy

18. As discussed in previous staff reports,[7] **the authorities have been implementing wide-ranging structural reforms and pursuing prudent macroeconomic policies,** supported by the PRGF arrangement since 2000. As a result, real GDP per capita growth has risen by over 3 percent a year on average, a stable macroeconomic environment has been maintained, inflation kept low, and foreign exchange reserves built up. **However, with per capita income still around US$100, Ethiopia remains one of the poorest countries in the world and continues to face major challenges**. The authorities are fully aware of the critical importance of achieving high real GDP growth over the medium term to reduce poverty, and, therefore, of the need to continue implementing prudent macroeconomic policies and structural reforms that liberalize the economy further and improve its competitiveness.

19. Against this background, the second annual PRGF-supported program has been designed in the context of an updated medium-term framework (for 2001/02 – 2004/05) that continues to stress (a) the reorientation of budgetary resources from defense toward poverty alleviation outlays; (b) tax reforms that lay the foundation for strong revenue performance; (c) improved monetary management and financial sector reform; and (d) capacity building and regulatory reforms to promote private sector development. The medium-term objectives

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[7] For more details, see EBS/01/108 (7/5/01) and EBS/02/37 (3/4/02).

are (a) to achieve an annual real GDP growth of about 6 percent; (b) to limit inflation to a low rate of about 3 percent on average; and (c) to reduce the external current account deficit (including official transfers) to 4 percent of GDP by 2004/05. The projected medium-term annual real GDP growth rate of 6 percent reflects an annual average growth of 5 percent in agriculture, about 6 percent in services, and about 8 percent in industry (the latter, however, from a low base).

20. This scenario takes into account the concessional external assistance that was identified at the time of the HIPC Initiative decision point under the baseline scenario, the overall fiscal deficit (including grants and excluding special programs that will end in 2003/04) is projected to be reduced from 9.9 percent of GDP (7.9 percent excluding special programs) in 2001/02 to 4.7 percent in 2004/05.

21. However, while the projections for 2002/03 under the PRGF and PRSP are the same, the PRSP presents a more ambitious scenario for 2003/04-2004/05, which aims at achieving an annual rate of real GDP growth of 7 percent and envisages higher expenditures in priority areas that would result in an overall fiscal deficit of 6.7 percent of GDP in 2004/05. The authorities reiterated their commitments to executing the program supported by the PRGF arrangement, especially to the pursuit of a prudent and sustainable fiscal policy over the medium term. However, they stressed the need to accelerate the development program to help reduce poverty at a faster pace. Thus, the macroeconomic framework in the PRSP is based on a scenario under which additional external assistance for 2003/04-2004/05 would become available from the World Bank in the context of the forthcoming Country Assistance Strategy. In the authorities' view, such additional financing would keep the fiscal stance over the medium term consistent with a sustainable external current account deficit and with a monetary policy that targets an inflation rate of 5 percent a year, while allowing exchange rate flexibility and a further buildup of international reserves. The government recognizes that a major improvement in domestic revenue mobilization will be the key to accommodating the level of public services needed to support Ethiopia's economic development and avoiding an unsustainable accumulation of debt. In this context, understandings were reached with the authorities and the World Bank staff to carefully assess future potential IDA disbursements, and ensure that the resources will be spent efficiently on poverty-related sectors and that they do not jeopardize Ethiopia's macroeconomic stability and external debt sustainability.[8]

22. In addition to sound macroeconomic policies, wide-ranging reforms across sectors to liberalize the agricultural and nonagricultural sectors of the Ethiopian economy and increase national savings and investment will be necessary. As externally funded post-conflict reconstruction and demobilization programs end, public investment is expected to return to

[8] As discussed at the time of the HIPC Decision Point (EBS/01/174, 10/16/01), even the baseline scenario, although achievable, will require continued implementation of sound policies and favorable exogenous developments.

sustainable levels. Major capacity and infrastructure expansions, the privatization of a large number of public enterprises, and financial sector reform would create room for private sector activity and spur growth.

23. **The sensitivity of export performance to commodity price shocks and weather patterns underscores the need to diversify exports in the medium term.** To this end, the authorities will need to persist with the implementation of broad-ranging reforms, including trade and investment liberalization, competition enhancement, improvements in infrastructure (transport and shipping costs amount to 15-20 percent of the f.o.b. export price for some products), disease control programs and a third-party certification system for livestock exports,[9] and improved financing for exports. The analysis conducted in the HIPC Initiative decision point document (EBS/01/174, 10/16/01) highlights the sensitivity of the medium-term balance of payments to adverse shocks, in particular to the growth rates of real GDP and export volume, and to export prices. For instance, if export growth were 1.5 percentage points below the baseline starting in 2003/04 it would take four additional years (until 2010/11) to bring the net present value (NPV) of debt-to-exports ratio below the 150 percent threshold. The same would be true if coffee prices were 25 percent below the baseline, or if the proportion of grants in external financing decreased by 20 percentage points. This sensitivity analysis, as well as the debt sustainability analysis, will be updated in the context of the HIPC Initiative completion point discussions in mid-2003.

B. Macroeconomic Objectives and Policies for 2002/03

24. The macroeconomic framework for 2002/03 was updated in light of recent developments and the latest World Economy Outlook (WEO) projections. The program for 2002/03 projects real GDP growth of 6 percent, spurred by an increase of investment from 18 percent of GDP in 2000/01 to 20.4 percent in 2002/03. Following the bumper crop in 2000/0l, growth of agricultural output would return to a more sustainable pace. After two consecutive years of negative inflation, consumer prices are expected to rise by 4.5 percent on average in 2002/03, as food supply returns to a more normal level.[10] Exports are in line with initial projections, while imports are expected to be slightly higher. Reflecting these

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[9] While Ethiopia has one of Africa's largest livestock populations, neighboring countries have banned imports of, for instance, sheep, cattle, and raw skins owing to concerns about Rift Valley fever and rinder pest.

[10] After a deflation of 7 percent in 2001/02, reflecting a fall in food prices of 15 percent and an increase of nonfood prices of about 3 percent, average annual consumer price inflation is expected to reach 4.5 percent in 2002/03, as food prices are projected to rise by 6 percent. As discussed in Box 1, fluctuation in inflation largely reflects volatile supply conditions in the cereal market rather than demand pressures, as core (nonfood) consumer price inflation remained around 3 percent. In subsequent years, prudent fiscal and monetary policies are expected to help limit inflation to 3 percent.

developments, lower nominal GDP,[11] and larger-than-projected official transfers, the external current account deficit (including official transfers) is estimated at 6.6 percent of GDP in 2001/02. For 2002/03, exports are projected to rise by 9.4 percent as both the volume and price of coffee are expected to recover moderately. Imports are projected to rise by 3.7 percent (4 percent in volume terms). As official transfers would return to a more sustainable level, the current account deficit is expected to increase to 6.9 percent of GDP in 2002/03.

Fiscal policy

25. **The authorities are determined to pursue a prudent fiscal policy.** The overall budget deficit (including grants and special programs) in 2001/02 is estimated to have been contained within the original program target in absolute terms. However, with lower nominal GDP, the deficit is estimated to have been 9.9 percent of GDP (9.1 percent under the originally projected GDP). In discussing the budget for 2002/03, the authorities wished to have higher spending in priority areas and, thus, a higher deficit (Box 3). After thorough discussions, understandings were reached to revise the original deficit target of 7.8 percent of GDP upward to 9.7 percent to take into account lower nominal GDP (with an impact equivalent to 1 percentage point), and accommodate the initial cost of restructuring the CBE[12] and higher than initially projected social spending (food security, education, health, and rural development). This relaxation of the fiscal target is consistent with the macroeconomic and poverty reduction objectives of the program. Based on an expected substantial net recourse to external financing (entirely on concessional terms), net borrowing by the government from the banking system will be limited to birr 0.5 billion (0.9 percent of GDP) in 2002/03.[13]

26. To achieve the revenue target of 16.6 percent of GDP in 2002/03, revenue performance will benefit from the introduction of the VAT in January 2003 and an improvement in tax administration, especially through the recent strengthening of the large taxpayer unit. The revenue impact of the import tariff reform to be introduced by January 2003 is expected to be neutral. The authorities have accelerated the pace of implementation of the tax reform program, in particular the functioning of the large taxpayer unit, the activity

[11] Nominal GDP is estimated at birr 51,158 million in 2001/02 and birr 57,092 million in 2002/03, about 9 percent lower than initially projected.

[12] The initial cost is estimated at around birr 500 million (0.8 percent of GDP).

[13] Domestic public debt, which fell from 42.2 percent of GDP in 1999/2000 to 40.7 percent in 2000/01, is projected to increase to 41.6 percent in 2002/03.

Box 3. Ethiopia: Summary of Discussions on Fiscal Policy

As indicated in the table below, the authorities' original budget proposal for 2002/03 included (a) revenues higher than the mission's forecast by 1 percent of GDP, reflecting an increase of tax revenue of 1.4 percent of GDP in 2002/03, compared with 2001/02, as opposed to 0.4 percent estimated by staff; (b) slightly different information on external financing; and (c) 1.3 percent of GDP additional domestic bank financing. As a result, capital expenditure was 2 percent of GDP higher than under staff's projections, and recurrent expenditure 0.9 percent larger. The authorities viewed the net recourse to domestic bank credit to finance mostly poverty-targeted outlays (food security, health, education, and construction of roads and water facilities) as essential to increase aggregate demand, in view of the negative inflation, and to address urgent poverty needs.

The staff agreed to relax the original program objective of net reimbursement to the banking system but viewed the nonrecourse to domestic bank borrowing as critical for the following reasons: (a) depressed food prices result from oversupply of cereals, and will be reversed by tackling the problem of oversupply created by imported food aid in kind, including through urging donors to purchase local cereals; (b) the efficiency and sustainability of additional spending should be thoroughly examined; (c) poverty and capital spending has doubled in the last two years (moreover, future secured and sustainable external assistance could be incorporated in a supplementary budget); and (d) money creation would lead to more imports, thereby potentially endangering a still fragile net external reserve position.

Understandings were finally reached on revised fiscal targets based on more realistic revenue and external financing projections, and relaxing the program objective of net reimbursement to the banking system without endangering macroeconomic stability by excessive domestic bank borrowing. Additional spending will be in poverty-targeted sectors.

Ethiopia: General Government Operations, 2001/02-2002/03 1/

	2001/02		2002/03			
	EBS/02/37	Estimate	EBS/02/37	Mission	Authorities	Rev. Prog.
			(In millions of birr)			
Total revenue and grants	13,894	13,815	15,016	15,189	16,114	15,189
Revenue	11,306	11,091	12,459	12,441	13,025	12,441
Grants	2,587	2,724	2,558	2,748	3,089	2,748
Total expenditure and net lending (cash basis) 2/	17,856	17,864	18,697	19,234	20,851	19,734
Recurrent expenditure 2/	11,366	11,184	11,834	11,948	12,369	12,310
Capital expenditure 2/	6,489	6,680	6,864	7,286	8,482	7,424
Special programs	1,287	1,020	1,210	982	1,285	982
Overall balance						
Including grants	-5,249	-5,069	-4,891	-5,028	-6,023	-5,527
Excluding grants	-7,837	-7,793	-7,448	-7,775	-9,112	-8,275
Financing	5,249	5,069	4,891	5,028	6,023	5,527
External (net)	4,849	4,669	4,698	4,677	4,877	4,677
Domestic(net)	0	200	-157	0	746	500
Of which: Banking system	-422	0	-534	0	746	500
Privatization	400	200	350	350	400	350
			(In percentage of GDP)			
Total revenue and grants	24.2	27.0	23.9	26.6	28.2	26.6
Revenue	19.7	21.7	19.8	21.8	22.8	21.8
Grants	4.5	5.3	4.1	4.8	5.4	4.8
Total expenditure and net lending (cash basis) 2/	31.1	34.9	29.8	33.7	36.5	34.6
Recurrent expenditure 2/	19.8	21.9	18.8	20.8	21.7	21.6
Capital expenditure 2/	11.3	13.1	10.9	12.9	14.9	13.0
Special programs	2.2	2.0	1.9	1.7	2.3	1.7
Overall balance						
Including grants	-9.1	-9.9	-7.8	-8.8	-10.5	-9.7
Excluding grants	-13.6	-15.2	-11.9	-13.6	-16.0	-14.5
Financing	9.1	9.9	7.8	8.8	10.5	9.7
External (net)	8.4	9.1	7.5	8.2	8.5	8.2
Domestic(net)	0.0	0.4	-0.2	0.0	1.3	0.9
Of which: banking system	-0.7	0.0	-0.8	0.0	1.3	0.9
Privatization	0.7	0.4	0.6	0.6	0.7	0.6
Memorandum item:						
GDP (in millions of birr)	57,496	51,158	62,845	57,092	57,092	57,092

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

1/ Fiscal year ending July 7.
2/ Excluding special programs (demobilization and reconstruction).

of the tax reform task force, the implementation of the tax identification number (TIN) pilot project, and the progress made in the preparation for the introduction of the VAT by January 2003 (performance criterion).[14]

27. **Total outlays (including special programs) are targeted at 34.6 percent of GDP in 2002/03**. The wage bill is to be limited to 7.8 percent of GDP in 2002/03, while defense outlays are to be maintained at the nominal level of the previous year, thereby declining as a ratio to GDP by 0.6 percentage point, to 5.3 percent. Poverty-targeted spending is to be raised to 18.4 percent of GDP (including 1.4 percent of GDP from HIPC Initiative relief). Capital outlays are to increase by 6 percent as project implementation improves and external disbursements continue to rise. As noted above, the authorities agreed that the high level of potential disbursements planned under the World Bank's forthcoming Country Assistance Strategy, and possibly from other donors, will need to be carefully assessed and spent efficiently on poverty-related sectors, while making sure that they do not jeopardize Ethiopia's external debt sustainability. Any additional secured commitment will be added to the budget only after understanding has been reached in the context of the fourth review under the PRGF arrangement. **Progress is being made in improving the planning, tracking, and reporting of public expenditure** (Box 4), particularly with a view to consolidating federal and regional budgets for both the past year and the current year—including all extrabudgetary funds and accounts—by September 2002 (benchmark). The staff stressed the importance of improving the effectiveness, reporting and monitoring of local government expenditures before further decentralizing public spending.

Monetary and financial sector issues

28. The monetary program for 2002/03 was updated, with a view to achieving the inflation and international reserve targets under the program. Money supply is projected to rise by about 12.4 percent in 2002/03, in line with the growth of nominal GDP. The planned limiting of the government's recourse to banking system credit is consistent with these targets and provides room for an adequate increase in credit to the nongovernment sector. Prudent financial policies are expected to contribute to maintaining the core (noncereal) inflation rate at about 3 percent in 2002/03. The staff urged the authorities to keep the interest rate policy under review, and to maintain positive real interest rates.

[14] More recently, however, there were some delays in the computerization of the TIN and VAT projects because of differences of views between the authorities and the contractors. The staff encouraged the authorities to resolve the differences and make progress in these critical areas.

Box 4. Ethiopia: Public Expenditure Management

The government has recently embarked on a comprehensive reform program of the public expenditure management system to address some of the key challenges it is facing, including (a) the formulation of budgets that integrate extrabudgetary expenditures and revenues such as food aid; (b) the continuing decentralization of expenditures to the *woreda* (district) level, with a view to improving the allocation and efficiency of local services delivery while ensuring an efficient assignment of expenditure and revenue responsibilities; (c) the strengthening of the budget preparation process through, inter alia, strict adherence to the financial calendar; (d) the introduction of an integrated, computerized financial information management system; and (e) the monitoring of expenditure execution in the priority sectors, particularly poverty-related spending.

These reforms are taking place within a decentralized system with regions collecting only 15-20 percent of general government revenues but accounting for nearly 35-40 percent of total spending and as much as 70 percent of social expenditure. While regions are heavily dependent on federal subsidies, and are not permitted to borrow from external sources, they enjoy considerable autonomy in expenditure allocations. The government has begun implementing a strategy to further decentralize expenditure to the *woreda* level, while improving capacity at all levels of government. In this context, the authorities will review intergovernmental relationships with regard to revenue and expenditure at the federal, regional, and *woreda* levels.

Key short-term reforms that the government has started to implement include (a) *budget formulation*—the introduction of a three-year macroeconomic expenditure framework at the federal level; the consolidation of federal and regional budgets (ex ante), including all extrabudgetary funds and accounts, by September 2002; (b) *budget execution*—the introduction of cost center budgeting, modified cash (commitment) accounting, double-entry bookkeeping at the federal level, and in the southern region; and the establishment of a working group to reconcile monetary and fiscal accounts, starting with 2001/02; and (c) *budget reporting*— the establishment of a working group to consolidate federal and regional budget outturns (ex post), including all extrabudgetary funds and accounts; the start of an integrated financial management information system (IFMIS) pilot project for five federal agencies; and, with the support of donors, the review of the institutional and legal framework for control, and of internal and external audit (including making the Auditor General independent).

Key long-term reforms include the following: (a) *budget formulation*—the implementation of a comprehensive budgetary classification at regional levels, and the inclusion of donor activities into federal and regional budgets; (b) *budget execution*—the strengthening of control and internal audit, and the adoption of a revised procurement code; and (c) *budget reporting*—the consolidation of federal and regional budget accounts at the beginning of the year, and the maintenance and computerization of uniform accounting procedures.

29. **The authorities continue to implement reforms aimed at strengthening the financial sector and improving its competitiveness.** The measures being implemented under the second annual program include (a) revising the directive on provisioning for nonperforming loans and other doubtful assets to bring it more in line with international best practice (prior action); (b) taking steps to strengthen the NBE, following the completion of the ongoing comprehensive study of it, including as necessary, revising the existing Banking Act to increase the NBE's autonomy by end-December 2002; (c) ensuring that the Construction and Business Bank is brought to the point of sale by end-December 2002 after its balance sheet has been restructured on the basis of the NBE's recommendations; (d) adopting a restructuring plan to address the weak financial condition of the Development Bank of Ethiopia by end-September 2002; and (e) allowing private banks to enter into management contracts with foreign institutions (a HIPC Initiative completion point trigger; done). The development of microfinancing institutions is being fostered. The authorities will also continue to implement the recommendations of the safeguards assessment, and will complete this task by end-December 2002.

30. **With respect to the CBE,** a performance contract was signed by the government and the new CBE management on June 28, 2002 to ensure that the CBE is operated effectively, on a commercial basis, so as to achieve the improvements in financial performance recommended by the audit carried out by Ernst & Young in 2000. The credit approval and monitoring process is being strengthened; lending authority has been transferred from the board of the CBE to management; and an audit committee was created at the board to oversee financial performance. The new management of CBE has autonomy in decision making, including on staffing, meeting performance targets, and pursuing delinquent borrowers, as well as on taking steps to strengthen the CBE's cost competitiveness and profitability. The CBE will also (a) hire consultants from reputable foreign institutions by end-September 2002 to assist the new management; (b) strictly adhere to the reserve requirement and the new provisioning directive; (c) reduce nonperforming loans (NPLs) by birr 0.8 billion (8 percent of total loans), including through write-offs, by end-September 2002 (benchmark); and (d) prepare a financial restructuring plan by end-March 2003. The authorities have also decided to have a financial audit of the CBE conducted by an internationally reputable firm (prior action), to be completed by end-January 2003 (benchmark). The terms of reference of the audit were tendered on July 13, 2002. The restructuring plan will be based on this audit and should seek a significant reduction of NPLs and the recapitalization of the CBE on a timely basis. As implementation of this plan will be an important aspect of the third annual program, details of the plan will need to be developed as part of the discussion on that program. The investigation related to the arrest of the CBE's managers on corruption charges is continuing.

31. **The staff urged the authorities to enhance competition in the financial sector,** either through a gradual entry of foreign banks into the sector by initially allowing foreign minority shareholding in private domestic banks (as proposed in the context of the second review), or through reaching understanding on a timetable for the breaking up or privatization of the CBE as part of the restructuring plan. However, as explained in Box 2, the authorities said that they were not ready at this stage to take these measures and

considered that priority should be given first to strengthening the financial sector and enhancing the supervisory capacity of the central bank.

External sector and balance of payments outlook

32. **The balance of payments projections for 2002/03 and the medium term have been updated,** taking into account the most recent revisions to the WEO, and the latest available information on coffee exports and food relief. The current scenario for 2002/03 projects a small widening in the external current account deficit (including official transfers) to 6.9 percent of GDP and a financing requirement (nonproject), after Fund assistance and already secured bilateral debt relief and assistance, of US$283 million (equivalent to 4.3 percent of GDP) to be fully covered by World Bank balance of payments support (US$120 million), the African Development Bank (AfDB) (US$24 million), the European Union (US$40 million), and interim assistance under the enhanced HIPC Initiative (US$99 million).

33. The Paris Club provided a flow rescheduling on Cologne terms after Ethiopia reached the enhanced HIPC Initiative decision point. The bilateral agreements following the Paris Club meetings on April 5, 2001 and April 12, 2002 are being finalized, and progress is being made in the bilateral negotiations with non-Paris Club creditors. The staff urged the authorities to improve the debt-monitoring system and debt statistics, and encouraged them to implement a comprehensive debt-management strategy. Repayments to the Fund will remain small in relation to projected exports of good and services, and Ethiopia is expected to meet its future (post-HIPC Initiative relief) obligations in a timely manner (Table 8).

34. **Understandings were reached on an action plan to reduce by January 2003 the average (nonweighted) import tariff from the existing level of 19½ percent to 17½ percent.**[15] The authorities intend to lower the maximum tariff from 40 percent to 35 percent and reduce the number of bands from 7 to 5. A study on effective protection, as well as on the progressive elimination of tax and duty exemptions, is being finalized by the authorities and will guide Ethiopia's trade reform efforts in the future.

35. **Ethiopia will continue to pursue a flexible exchange rate policy under the program.** With the elimination of the wholesale foreign exchange market, and the shift to a daily interbank market, the NBE has substantially reduced its participation in the foreign exchange market (foreign exchange sales have declined by over 50 percent since October 2001). This development has been aided by stricter enforcement of the regulations on banks' foreign exchange position. The birr depreciated by roughly 18 percent in real effective terms

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[15] All export taxes have been eliminated, except for an export duty of 6.5 percent on coffee applicable only if prices exceed 105 cents per lb for washed coffee and 70 cents per lb for sun dried coffee. This duty has largely not been levied since May 2001 as prices fell below those levels.

over the last two fiscal years while the terms of trade deteriorated by 13 percent.[16] The depreciation, together with a projected improvement in the terms of trade—particularly the gradual recovery of coffee prices—should result in a pickup in export growth in 2002/03 and the medium term.

36. The staff reviewed whether Ethiopia's legislation was in compliance with the obligations of Article VIII, Sections 2, 3, and 4 of the Fund's Articles of Agreement. **Significant progress has been made in eliminating most of the previously identified exchange restrictions**, including the termination of the NBE's weekly wholesale foreign exchange auction and its replacement by the interbank market on October 24, 2001. The staff encouraged the authorities to eliminate the few exchange restrictions that existed prior to the PRGF arrangement, and to accept the obligations of Article VIII, Sections 2, 3, and 4. The remaining restrictions relate to (a) the tax certification requirement for repatriation of investment income; (b) restrictions on repayment of legally entered into external loans and supplies and foreign partner's credits; (c) rules for issuance of import permits; and (d) the requirement to provide a clearance certificate from NBE to obtain import permits.[17]

C. Social Policies and PRSP

37. **The mission, in collaboration with World Bank staff, discussed the draft full PRSP.** Wide-ranging consultations at the district, regional, and federal levels were completed in March 2002. The staff team reiterated the importance of ensuring that the full PRSP includes (a) an in-depth analysis of the sources of growth and its links to poverty, (b) a full-fledged HIV/AIDS strategy, (c) a coherent macroeconomic framework, (d) a detailed costing of identified actions, and (e) an action plan with monitorable indicators. An assessment of the social impact under the PRGF-supported program was provided in Box 2 of EBS/02/37 (3/4/02). The authorities intend to carry out social impact analysis of key policies, including the VAT, with assistance from donors.

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[16] Over the past twelve months, the terms of trade deterioration amounted to 6.6 percent, driven largely by higher fuel and lower coffee prices.

[17] The authorities indicated their intention to accept the obligations under Article VIII in the near future. However, they said that, of the four restrictions mentioned above, (b) was a restriction under capital and not current transactions and that they did not consider (a), (c), and (d) as restrictions of current transactions. The staff explained that (b) was a restriction under Article VIII because payments of moderate amount for the amortization of loans were payments for current transactions in Article XXX(*d*)(3) of the IMF's Articles of Agreement. A clarification of the regulations for the other three issues was needed to eliminate current exchange restrictions; the staff will provide specific recommendations to revise the regulations accordingly.

D. Other Structural Reforms

38. The authorities are implementing, in consultation with the World Bank, structural reforms that are conducive to growth and poverty reduction, including agricultural reform, capacity building, export promotion, the strengthening of the existing legal and regulatory framework, and civil service reform (Box 5). The authorities agreed with the staff that to spur private sector activity, stronger efforts were needed to accelerate the privatization program, including by adopting a more aggressive marketing campaign for the enterprises that have been brought up to the point of sale. With the assistance of MIGA, the authorities are also working to settle in the near future expropriation claims.

E. Statistical Issues

39. **The mission urged the authorities to intensify their efforts to improve the compilation of macroeconomic statistics on a timely basis.** Progress is being made in reconciling monetary and fiscal accounts (benchmark for December 2002),[18] and in implementing the recommendations of the recent multisector statistics technical assistance mission, including the revision of monetary statistics and the coverage of international reserves. In line with Fund technical assistance recommendations, the authorities have released a new and improved consumer price index (CPI). Ethiopia has signaled its intention to participate in the General Data Dissemination Supplement (GDDS), and toward this end, it has appointed a national coordinator.

F. PRGF Arrangement Monitoring

40. Understandings were reached on quantitative performance criteria for end-September 2002, benchmarks for end-December 2002, and indicative targets for end-March 2003, as well as on structural performance criteria and benchmarks through December 2002 (Appendix I, Tables 1 and 2). The following prior actions were included: (a) the submission to the Parliament of a 2002/03 budget in line with program assumptions (done on June 28, 2002); (b) the opening of a bid for a financial audit of the CBE by an internationally reputable audit firm (issued in *The Economist* on July 13, 2002); and (c) the revision of the provisioning guidelines by end-August 2002 (Appendix I, Table 3). The fourth program review, to be completed by January 2003, will assess progress under the second annual program, reach understandings for the third annual program (October 2002 – September 2003), and reach understandings on performance criteria and benchmarks for the second half of the 2002/03 program year.

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[18] The benchmark is delayed from September to December 2002 because of the needed technical assistance, which is being provided by the Fund.

Box 5. Ethiopia: Structural Conditionality

Structural conditionality in the second annual program

Conditionality under the second annual program (Appendix I, Tables 2 and 3) relates to (a) **restructuring the financial sector, in particular the Commercial Bank of Ethiopia**; (b) **enhancing the safeguards of the National Bank of Ethiopia**; (c) **improving tax administration and revenue;** and (d) **improving public expenditure management**. All prior actions, benchmarks, and performance criteria were completed as scheduled, with the exception of the benchmark on the regulation for the provisioning by banks for nonperforming loans which was adopted, as scheduled, but is to be revised as a prior action to bring it more in line with international best practice.

Status of structural conditionality under the first annual program

The status of structural conditionality benchmarks and performance criteria under the first annual program is presented in EBS/02/37 (3/4/02; Appendix 1, Table 3). All the prior actions, the benchmark on the establishment of a tax reform task force by April 31, 2001, and the performance criteria pertaining to the signature of a management contract for CBE by June 30, 2001, the establishment of a fully operational large taxpayer unit by July 1, 2001, and the submission of draft VAT legislation to parliament by October 1, 2001, were completed as scheduled. The benchmark pertaining to the termination of the wholesale foreign exchange auction and the move of foreign exchange operations to the interbank market, which had been set for October 1, 2001, was delayed until October 24 because the provision of technical assistance was deferred as a result of the travel suspension related to the events of September 11, 2001.

Structural areas covered by World Bank lending and conditionality

Conditionality related to the World Bank's Economic Structural Adjustment Credit is concentrated in the following areas:

- private sector development and export competitiveness, including the approval by the Council of Ministers of a draft trade practice proclamation, a draft federal urban land lease proclamation, and a draft revised investment code; the adoption of a directive regulating shipping services, and of a directive regulating the implementation of the bonded manufacturing warehouse scheme; and the preparation of studies on markets for rawhides and skin, and on coffee marketing;
- civil service reform, including approval of the civil service grievance system and procedures by the Council of Ministers, the completion of a diagnostic survey of job classification and grading, and the launch of a labor market survey on wage differentials between private and public sector jobs; and
- public expenditure management and services delivery, including the closure and consolidation of federal and regional accounts up to 1998/99 and the initiation of financial audits for 1998/99, and the automation of 50 percent of all personnel records at the federal level, with an action plan for the reconciliation with payroll data.

The World Bank will continue to support government activities in the aforementioned areas, and in capacity building and agricultural development. It has also participated, along with the Fund, in the evaluation of the financial sector and is active in supporting Ethiopia's demobilization and rehabilitation programs, as well as its HIV/AIDS program.

Other relevant structural measures not included in the current program

Since 1995, the authorities have embarked on a comprehensive privatization program. In the first nine months of 2001/02, twenty public entities were put up for sale and one entity sold. The authorities intend to accelerate the privatization program by bringing another 38 entities to the point of sale in 2002/03.

IV. Staff Appraisal

41. Since 2000, Ethiopia has been implementing sound macroeconomic policies and wide-ranging structural reforms to liberalize the economy. As a result, per capita real GDP rose for the fourth year in a row. However, Ethiopia remains one of the poorest countries in the world and faces major challenges, particularly the achievement of high rates of real GDP growth over the medium term to help reduce poverty. To this end, the authorities need to continue to implement structural reforms that enhance the efficiency of the economy and improve its competitiveness, while continuing with prudent macroeconomic policies, including a sustainable fiscal policy. These reforms and policies are key elements of the second annual PRGF-supported program.

42. Performance under the second annual program remains satisfactory, and further progress was made toward restoring peaceful conditions between Ethiopia and Eritrea. Real GDP growth, although slightly lower than the program projection, is estimated at 5 percent in 2001/02. Consumer price inflation remained negative, reflecting the continued food surplus. The authorities are concerned about the continued drop of producer prices of cereals and coffee, the latter on account of depressed world prices. The authorities are taking actions to mitigate the impact of these developments, and hope to discuss with donors the need for them to purchase more cereals locally in providing food aid to food-deficit areas, in order to prop up these prices. Fiscal performance in 2001/02 was broadly consistent with the program, as defense outlays were cut and social spending rose as programmed. With larger-than-projected official transfers, the external current account deficit is estimated to be slightly lower than projected for 2001/02. As a result, all the quantitative performance criteria and benchmarks for December 2001 and March 2002 were met. Structural benchmarks and performance criteria through March 2002 have been observed, although the revised regulation for the provisioning by banks for nonperforming loans and other doubtful assets is to be brought in line with international best practice by August 31, 2002.

43. Provided that the PRGF-supported program continues to be implemented effectively, its objectives are likely to be achieved. To this end, the staff urges the authorities to guard against slippages during the remainder of the program. Steadfast implementation of the program in three key areas will be crucial.

44. In the fiscal area, the authorities should persevere with their cautious expenditure policy. Some relaxation of the 2002/03 deficit target and modest bank financing are envisaged to accommodate higher priority spending. Nevertheless, a significant reduction of the fiscal deficit in 2003/04 and 2004/05, will be critical for macroeconomic stability in Ethiopia in the short and medium run and for debt sustainability over the long run. To avoid risking macroeconomic stability and debt sustainability, the macroeconomic framework described in the PRSP for the latter years will need to be carefully assessed once additional external financing is identified.

45. The staff welcomes the cuts in defense spending since the PRGF-supported program was adopted in late 2000, as well as the near doubling of social spending during that period.

The sustainable implementation of tax reforms will be critical to achieving the revenue target. The staff also welcomes the recent strengthening of the large taxpayer unit and urges the authorities to accelerate the preparation for the introduction of the VAT and the tariff reform in January 2003. The authorities also need to proceed decisively with their plans for improving the planning, tracking, and reporting of public spending, especially poverty-reducing spending.

46. In the monetary and exchange areas, the authorities should pursue vigorously their reform efforts aimed at strengthening the financial sector and enhancing its competitiveness, improving monetary management by using indirect policy instruments, and further strengthening market-based money and exchange management arrangements. The exchange rate regime and policy remain appropriate. The staff welcomes the ongoing efforts to address the difficulties of the largest state-owned bank, the CBE, including carrying out an audit by an internationally reputable firm, using international audit and accounting standards. However, the staff regrets that the authorities decided not to allow foreign entry in the financial sector to help increase competition at this stage.

47. Adherence to the agenda of other structural reforms is essential. The authorities, in consultation with the World Bank, need to continue to implement key structural reforms, focusing on public sector management, including civil service reform and public expenditure policy, and on private sector development. The government should also accelerate the privatization program to spur private sector activity. The staff welcomes the finalization of the full PRSP after a wide and full participation in the process by civil society and development partners.

48. With the continued implementation of sound policies and consolidation of the peace process, the medium-term outlook for the Ethiopian economy remains encouraging. In view of the satisfactory implementation of the program and the authorities' commitment to its success, the staff recommends that the present review under the PRGF arrangement be completed.

49. It is proposed that the next Article IV consultation with Ethiopia be held on the 24-month cycle.

Figure 1. Ethiopia: Selected Economic Indicators, 1998/99-2004/05 1/

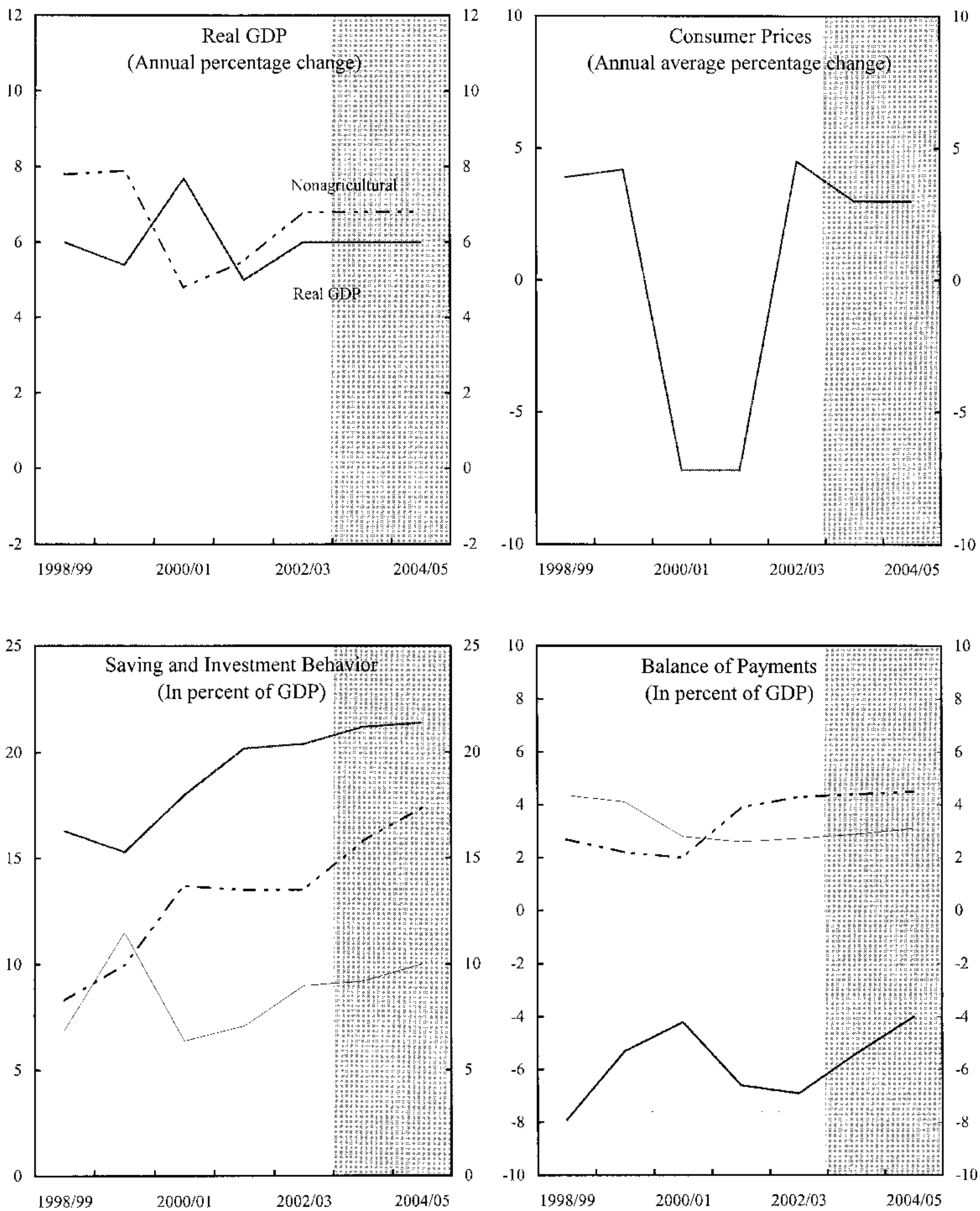
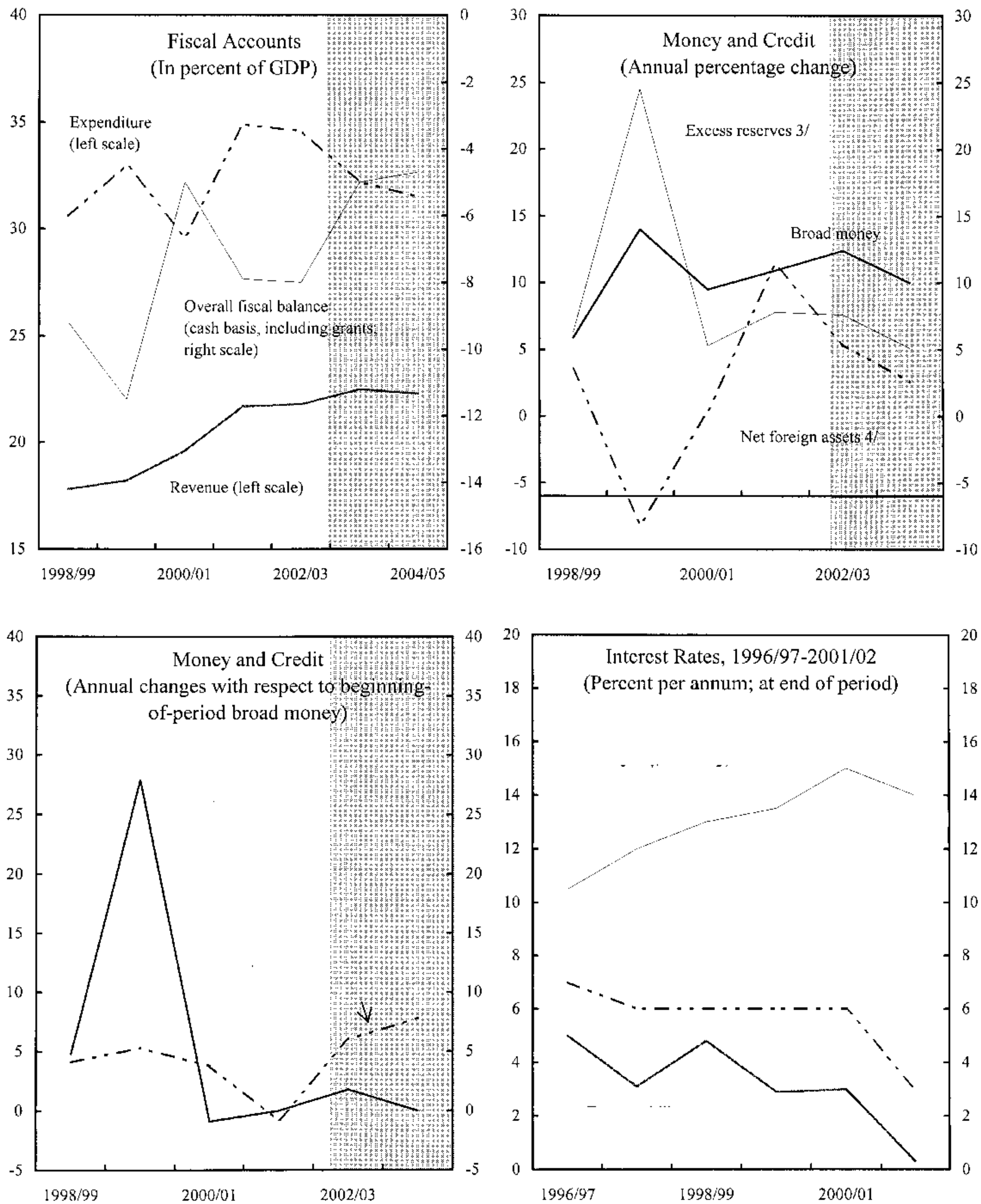


Figure 1. Ethiopia: Selected Economic Indicators, 1998/99-2004/05 1/ (concluded)



Sources: Ethiopian authorities; and staff estimates and projections.

1/ All data pertain to the period July 8-July 7. Shaded area indicates program period.

2/ In months of imports of goods and nonfactor services of the following year.

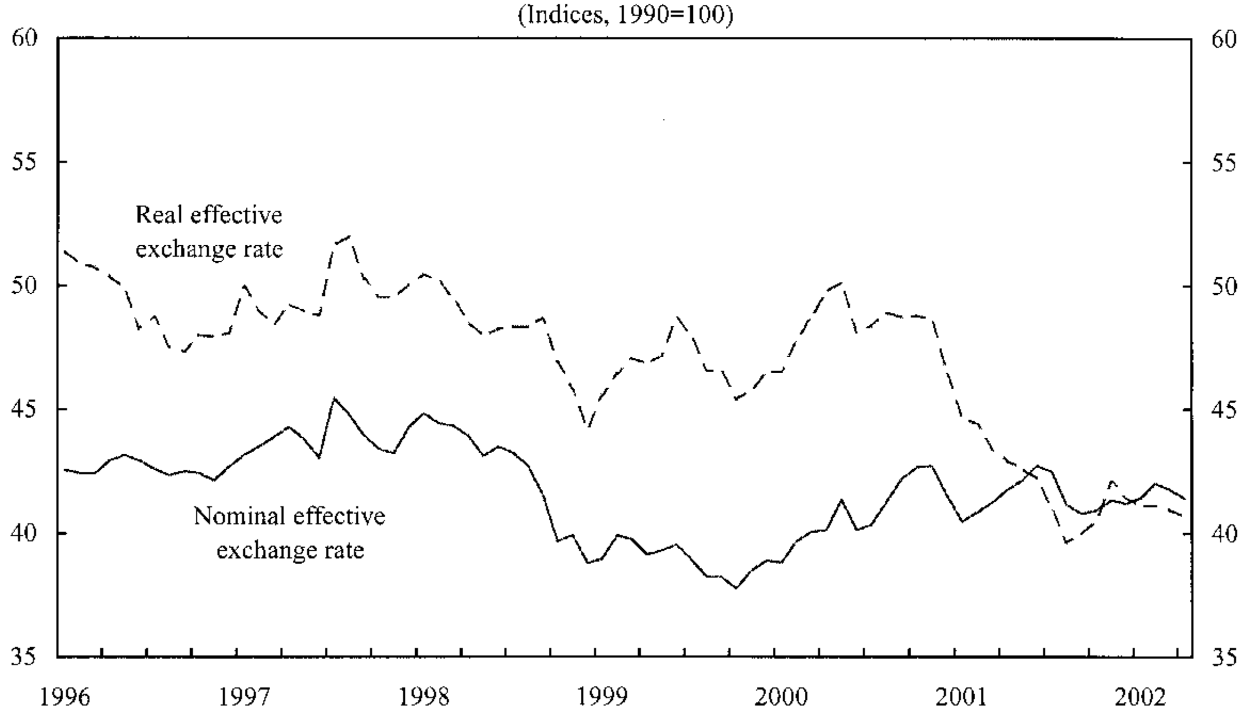
3/ In percent of deposits.

4/ Change in percent of beginning-of-period broad money.

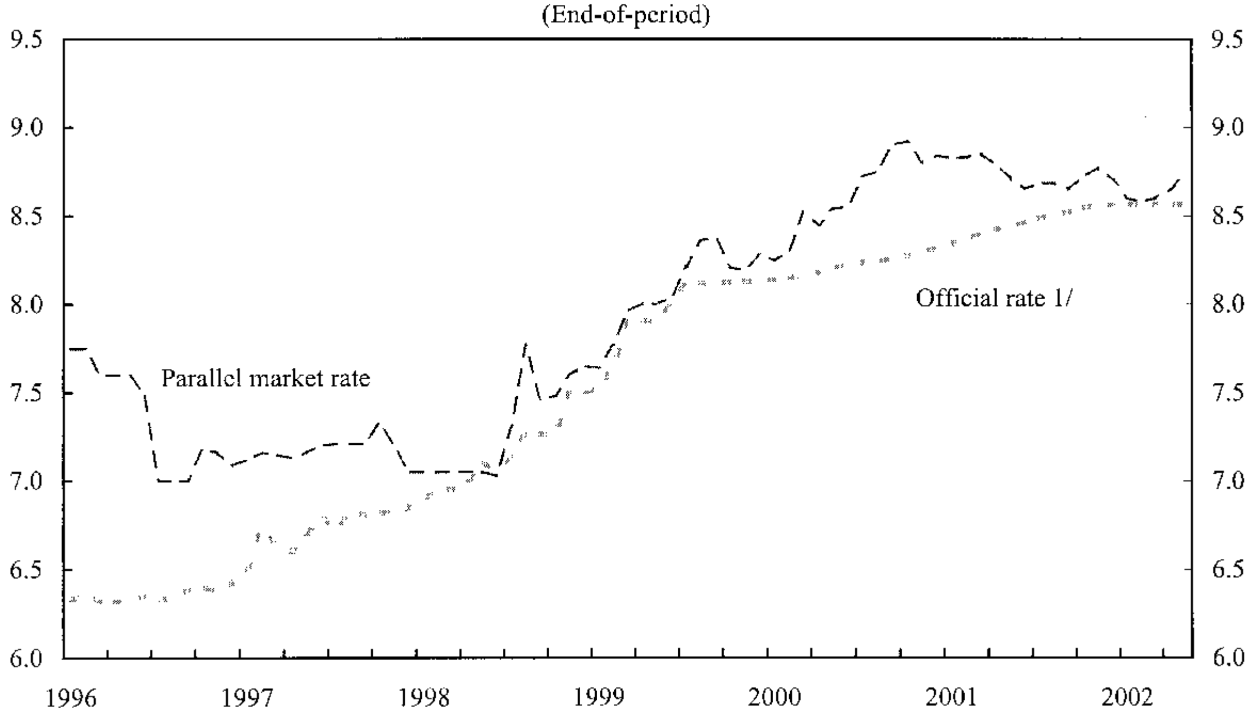
5/ Includes credit to public enterprises and the private sector.

Figure 2. Ethiopia: Exchange Rate Developments

Trade-Weighted Exchange Rates, January 1996-April 2002
(Indices, 1990=100)



Birr per U.S. Dollar Rates, January 1996-May 2002
(End-of-period)



Sources: IMF, Information Notice System; National Bank of Ethiopia; and staff estimates.

1/ Until September 2001, the marginal rate at the foreign exchange auction conducted by the National Bank of Ethiopia; thereafter, the transaction-weighted foreign exchange interbank market rate.

Table 1. Ethiopia: Schedule of Disbursements and Repayments Under the PRGF Arrangement, 2002-04

	Position on June 30, 2002	2002 July-Dec.	2003 Jan.-June	2003 July-Dec.	2004 Jan.-June	2004 July-Dec.
	(In millions of SDRs)					
Net use of Fund resources						
Repayments	...	6.4	5.0	5.0	4.4	4.4
Projected disbursements	...	10.4	10.4	10.4	10.4	0.0
Fund resources outstanding (end of period)	101.4	105.4	110.8	116.3	122.3	118.0
	(In percent of quota) 1/					
Net use of Fund resources						
Repayments	...	4.8	3.7	3.7	3.3	3.3
Projected disbursements	...	7.8	7.8	7.8	7.8	0.0
Fund resources outstanding (end of period)	75.8	78.8	82.9	87.0	91.5	88.2

Source: Fund staff calculations and projections.

1/ Quota of SDR 133.7 million.

Table 2. Ethiopia: Schedule of Remaining Disbursements Under the PRGF Arrangement, 2002-04

	Amount		Availability	Conditions Include:
	SDR	Percent of quota		
	10,429,000	7.8	September 2002	Completion of third review and observance of end-March 2002 performance criteria.
	10,429,000	7.8	January 2003	Completion of fourth review and observance of end-September 2002 performance criteria.
	10,429,000	7.8	7/7/2003 1/	Completion of fifth review and observance of end-March 2003 performance criteria.
	10,429,000	7.8	1/19/2004 1/	Completion of sixth review and observance of end-September 2003 performance criteria.
Total	41,716,000	75.0		

Source: Fund staff estimates and projections.

1/ These disbursements have not been included into the arrangement yet, but are envisaged for these dates.

Table 3. Ethiopia: Selected Economic and Financial Indicators, 1998/99-2004/05 1/

	1998/99	1999/00	2000/01	2001/02		2002/03		2003/04	2004/05
			Estimate	EBS/02/37	Estimate	EBS/02/37	Rev. Prog.	Rev. Proj.	
	(Annual percentage change)								
National income and prices									
GDP at constant prices (at factor cost)	6.0	5.4	7.7	5.8	5.0	6.0	6.0	6.0	6.0
GDP deflator	1.6	1.1	-8.2	2.4	-7.4	3.5	4.9	3.7	4.0
Consumer prices (period average)	3.9	4.2	-7.2	3.0	-7.2	3.0	4.5	3.0	3.0
External sector									
Exports, f.o.b.	-19.6	0.4	-9.3	-8.9	-9.3	10.1	9.4	12.7	16.0
Imports, c.i.f.	14.8	3.4	-3.4	2.6	4.7	3.8	3.7	4.9	4.9
Export volume	-1.4	20.5	-1.5	0.2	-0.4	7.5	7.2	7.0	8.0
Import volume	18.4	-17.9	-1.9	5.3	7.3	5.0	4.0	4.0	4.2
Terms of trade (deterioration -)	-15.9	-33.9	-6.3	-6.6	-6.6	3.6	2.3	4.4	6.7
Nominal effective exchange rate (end of period)	-9.1	1.5	6.5	...	...	...	...	...	...
Real effective exchange rate (end of period)	0.9	-1.2	-12.3	...	...	...	...	...	...
	(In percent of beginning-period stock of broad money, unless otherwise indicated)								
Money and credit									
Net foreign assets	3.6	-8.1	0.3	5.3	11.4	5.8	5.4	2.6	...
Net domestic assets	2.3	22.1	9.2	5.7	-0.5	4.2	7.1	7.5	...
Net claims on the government	4.8	27.9	-0.9	-1.7	0.0	-2.0	1.8	0.0	...
Credit to the nongovernment sector	4.1	5.3	3.8	7.7	-0.8	7.3	6.0	7.8	...
Broad money	5.9	14.0	9.5	11.1	10.9	9.9	12.4	10.0	...
Velocity (GDP/broad money)	2.5	2.3	2.1	2.1	1.9	2.1	1.9	1.9	...
Interest rates (in percent at end of period)									
Savings deposits (mandatory floor rate)	6.0	6.0	6.0	...	3.0	...	...	...	...
Lending rates (maximum rate)	13.0	13.5	15.0	...	14.0	...	...	...	...
Treasury bill (91-day maturity)	4.8	2.9	3.0	...	0.3	...	...	...	...
	(In percent of GDP, unless otherwise indicated)								
Financial balances									
Gross domestic saving	1.4	-0.1	2.2	2.4	1.5	4.3	3.5	5.6	7.3
Government saving	-0.6	-4.9	2.0	0.5	0.7	2.0	0.9	3.0	3.9
Private saving	2.0	4.8	0.2	1.9	0.8	2.3	2.5	2.5	3.4
Gross domestic investment	16.3	15.3	18.0	18.6	20.2	19.3	20.4	21.2	21.4
Government investment	7.9	5.3	8.9	11.2	12.6	10.7	12.5	11.5	10.8
Private investment	8.4	9.9	9.2	7.5	7.5	8.7	8.0	9.7	10.6
Resource gap	-14.9	-15.3	-15.8	-16.2	-18.6	-15.0	-17.0	-15.7	-14.1
External current account balance, including official transfers	-7.9	-5.3	-4.2	-7.1	-6.6	-6.2	-6.9	-5.4	-4.0
Saving-investment (government)	-6.5	-6.9	-1.6	-7.3	-6.2	-5.6	-7.9	-4.8	-3.3
Saving-investment (private)	-1.4	1.6	-2.7	0.2	-0.4	-0.5	1.0	-0.6	-0.6
External current account balance, excluding official transfers	-11.2	-9.8	-10.5	-11.5	-13.5	-10.2	-11.6	-10.0	-8.5
Government finances									
Revenue	17.8	18.3	19.6	19.7	21.7	19.8	21.8	22.5	22.3
Tax revenue	11.5	12.5	14.3	14.7	16.2	14.9	16.6	17.4	18.1
Nontax revenue	6.3	5.8	5.3	5.0	5.5	4.9	5.2	5.2	4.2
External grants	3.6	3.3	5.1	4.5	5.3	4.1	4.8	4.7	4.6
Expenditure and net lending 2/	30.6	33.1	29.6	31.1	34.9	29.8	34.6	32.2	31.5
Fiscal balance, excluding grants (cash basis) 2/	-12.9	-14.8	-10.0	-11.4	-13.2	-9.9	-12.8	-9.7	-9.2
Fiscal balance, including grants (cash basis) 2/	-9.2	-11.5	-5.0	-6.9	-7.9	-5.9	-8.0	-5.0	-4.7
Special programs 3/	0.0	0.0	0.8	2.2	2.0	1.9	1.7	1.4	0.0
Fiscal balance, including grants and special programs	-9.2	-11.5	-5.7	-9.1	-9.9	-7.8	-9.7	-6.4	-4.7
Total financing	9.2	11.5	5.7	9.1	9.9	7.8	9.7	6.4	4.7
External financing	3.5	1.7	4.0	8.4	9.1	7.5	8.2	5.5	4.2
Domestic financing (including residual)	4.1	8.6	1.0	0.0	0.4	-0.2	0.9	0.5	0.4
Privatization receipts	1.6	1.3	0.8	0.7	0.4	0.6	0.6	0.5	0.0
Domestic debt	31.2	42.2	40.3	40.7	40.7 #	40.9	41.6	41.9	42.3
External debt (including to Fund) 4/	82.4	85.7	90.1	91.6	102.3	90.0	98.5	93.3	86.8
External debt-service ratio 5/	63.3	52.2	23.2	22.7	22.4	20.6	20.7	18.7	16.9
Overall balance of payments (in millions of U.S. dollars)	-473	-366	-71	40	232	-93	5	-92	-86
Gross official reserves (in millions of U.S. dollars)	434	349	337	495	679	678	773	841	899
(in months of imports of goods and nonfactor services of following year)	2.7	2.2	2.0	2.9	3.9	3.8	4.3	4.4	4.5
GDP at current market prices (in millions of birr)	48,422	51,869	51,962	57,496	51,158	62,845	57,092	62,922	69,590
Exchange rate (birr per U.S. dollar; period average rate)	7.53	8.15	8.34	...	8.54	...	...	...	...

Sources: Ethiopian authorities; and staff estimates and projections.

1/ Data pertain to the period July 8-July 7.

2/ Excluding special programs.

3/ Demobilization and reconstruction.

4/ Before 1999/2000, post-debt relief; thereafter, pre-debt relief.

5/ Before debt relief; on an accrual basis; in percent of exports of goods and nonfactor services.

Table 4. Ethiopia: General Government Operations, 1999/2000-2004/05 1/
(In millions of birr)

	1999/00	2000/01	2001/02		2002/03					2003/04	2004/05
			EBS/02/37	Estimate	EBS/02/37	Revised Prog.				Revised Proj.	
						Sep.	Dec.	March	July 7		
Total revenue and grants	11,222	12,805	13,894	13,815	15,016	3,446	7,048	10,512	15,189	17,115	18,673
Revenue	9,498	10,177	11,306	11,091	12,459	2,970	5,953	8,752	12,441	14,186	15,499
Tax revenue (incl. measures)	6,482	7,440	8,446	8,296	9,362	2,377	4,750	6,909	9,464	10,940	12,591
Direct taxes	2,367	2,734	3,447	3,171	3,856	1,004	2,098	2,730	3,740	4,397	5,106
Indirect taxes	4,116	4,706	4,999	5,124	5,506	1,373	2,652	4,179	5,724	6,543	7,485
Domestic indirect taxes	1,440	1,381	1,775	1,590	2,045	413	862	1,359	1,862	2,240	2,651
Import duties and taxes	2,528	3,231	3,182	3,505	3,417	949	1,772	2,794	3,828	4,278	4,834
Export taxes	148	93	42	30	44	11	18	25	34	25	0
Nontax revenue	3,016	2,737	2,860	2,796	3,096	593	1,203	1,843	2,977	3,246	2,908
Grants	1,724	2,628	2,587	2,724	2,558	476	1,095	1,761	2,748	2,929	3,174
Total expenditure and net lending (cash basis) 2/	17,184	15,382	17,856	17,864	18,697	4,073	9,126	13,983	19,734	20,271	21,912
Recurrent expenditure 2/	13,742	10,379	11,366	11,184	11,834	2,648	5,882	8,882	12,310	12,714	13,594
Defense spending	6,842	3,307	3,000	3,000	2,824	590	1,268	2,004	3,000	3,000	3,000
Poverty-targeted expenditure	2,324	2,717	3,320	3,324	3,686	895	1,886	2,800	3,853	4,237	4,686
Of which: HIPC poverty-targeted expenditure	0	0	17	21	47	10	19	29	39	40	34
Interest payments (after traditional debt-relief mechanism)	1,122	1,080	1,248	969	1,280	277	649	926	1,280	1,311	1,559
Domestic interest and charges	723	575	669	545	682	177	347	484	686	692	832
External interest payments (after traditional debt-relief mechanism)	399	505	579	424	598	149	297	447	594	619	727
External assistance (food and other emergency aid)	1,289	978	782	1,006	876	206	553	729	902	886	882
Other	2,164	2,297	3,017	2,885	3,168	680	1,526	2,423	3,275	3,279	3,468
Net lending	0	0	0	0	0	0	0	0	0	0	0
Capital expenditure 2/	3,442	5,003	6,489	6,680	6,864	1,424	3,245	5,102	7,424	7,558	8,318
Of which: poverty-targeted expenditure	2,031	3,658	5,220	5,220	5,668	1,279	2,915	4,583	6,669	7,045	7,790
Of which: HIPC poverty-targeted expenditure	0	0	317	404	886	182	366	550	740	766	655
Balance, excl. special programs (cash basis)											
Including grants	-5,961	-2,577	-3,962	-4,049	-3,681	-627	-2,078	-3,471	-4,545	-3,157	-3,239
Excluding grants	-7,685	-5,205	-6,549	-6,773	-6,239	-1,103	-3,173	-5,232	-7,293	-6,085	-6,413
Special programs 3/	0	404	1,287	1,020	1,210	358	693	837	982	887	0
Overall balance											
Including grants	-5,961	-2,981	-5,249	-5,069	-4,891	-985	-2,771	-4,308	-5,527	-4,043	-3,239
Excluding grants	-7,685	-5,609	-7,837	-7,793	-7,448	-1,461	-3,866	-6,069	-8,275	-6,972	-6,413
Financing	5,961	2,981	5,249	5,069	4,891	985	2,771	4,308	5,527	4,043	3,239
External (net)	868	2,070	4,849	4,669	4,698	985	3,051	3,908	4,677	3,444	2,939
Gross borrowing	1,366	2,686	5,103	4,858	4,563	984	3,000	3,817	4,555	3,574	3,112
HIPC Initiative relief	0	0	334	425	932	192	385	579	779	806	689
Amortization repayment (after traditional debt-relief mechanism)	-498	-616	-588	-614	-797	-191	-333	-488	-657	-937	-862
Domestic(net)	4,975	57	0	200	-157	0	-330	200	500	300	300
Banking system	5,499	-213	-422	0	-534	0	-130	200	500	0	0
Nonbank sources	-524	270	422	200	377	0	-200	0	0	300	300
Privatization	650	400	400	200	350	0	50	200	350	300	0
Float/unidentified financing	-532	454	0	0	0	0	0	0	0	0	0
Memorandum items:											
HIPC Initiative relief on interest	0	0	235	235	468	103	207	311	420	328	325
HIPC Initiative relief on amortization	0	0	99	190	462	89	178	269	359	479	364
Gross domestic product	51,869	51,962	57,496	51,158	62,845	...	...	...	57,092	62,922	69,590

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

1/ Fiscal year ending July 7.
2/ Excluding special programs (demobilization and reconstruction).
3/ Demobilization and reconstruction.

Table 5. Ethiopia: General Government Operations, 1999/2000-2004/05 1/
(In percentage of GDP)

	1999/00	2000/01	2001/02		2002/03		2003/04	2004/05
		Estimate	EBS/02/37	Estimate	EBS/02/37	Revised Prog.	Revised Proj.	
Total revenue and grants	21.6	24.6	24.2	27.0	23.9	26.6	27.2	26.8
Revenue	18.3	19.6	19.7	21.7	19.8	21.8	22.5	22.3
Tax revenue (incl. measures)	12.5	14.3	14.7	16.2	14.9	16.6	17.4	18.1
Direct taxes	4.6	5.3	6.0	6.2	6.1	6.6	7.0	7.3
Indirect taxes	7.9	9.1	8.7	10.0	8.8	10.0	10.4	10.8
Domestic indirect taxes	2.8	2.7	3.1	3.1	3.3	3.3	3.6	3.8
Import duties and taxes	4.9	6.2	5.5	6.9	5.4	6.7	6.8	6.9
Export taxes	0.3	0.2	0.1	0.1	0.1	0.1	0.0	0.0
Nontax revenue	5.8	5.3	5.0	5.5	4.9	5.2	5.2	4.2
Grants	3.3	5.1	4.5	5.3	4.1	4.8	4.7	4.6
Total expenditure and net lending (cash basis) 2/	33.1	29.6	31.1	34.9	29.8	34.6	32.2	31.5
Recurrent expenditure 2/	26.5	20.0	19.8	21.9	18.8	21.6	20.2	19.5
Defense spending	13.2	6.4	5.2	5.9	4.5	5.3	4.8	4.3
Poverty-targeted expenditure	4.5	5.2	5.8	6.5	5.9	6.7	6.7	6.7
Of which: HIPC poverty-targeted expenditure	0.0	0.0	0.0	0.0	0.1	0.1	0.1	0.0
Interest payments (after traditional debt-relief mechanism)	2.2	2.1	2.2	1.9	2.0	2.2	2.1	2.2
Domestic interest and charges	1.4	1.1	1.2	1.1	1.3	1.2	1.1	1.2
External interest payments (after traditional debt-relief mechanism)	0.8	1.0	1.0	0.8	1.0	1.0	1.0	1.0
External assistance (food and other emergency aid)	2.5	1.9	1.4	2.0	1.4	1.6	1.4	1.3
Other	4.2	4.4	5.2	5.6	5.0	5.7	5.2	5.0
Net lending	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Capital expenditure 2/	6.6	9.6	11.3	13.1	10.9	13.0	12.0	12.0
Of which: poverty-targeted expenditure	3.9	7.0	9.1	10.2	9.0	11.7	11.2	11.2
Of which: HIPC poverty-targeted expenditure	0.0	0.0	0.6	0.8	1.4	1.3	1.2	0.9
Balance, excl. special programs (cash basis)								
Including grants	-11.5	-5.0	-6.9	-7.9	-5.9	-8.0	-5.0	-4.7
Excluding grants	-14.8	-10.0	-11.4	-13.2	-9.9	-12.8	-9.7	-9.2
Special programs 3/	0.0	0.8	2.2	2.0	1.9	1.7	1.4	0.0
Overall balance								
Including grants	-11.5	-5.7	-9.1	-9.9	-7.8	-9.7	-6.4	-4.7
Excluding grants	-14.8	-10.8	-13.6	-15.2	-11.9	-14.5	-11.1	-9.2
Financing	11.5	5.7	9.1	9.9	7.8	9.7	6.4	4.7
External (net)	1.7	4.0	8.4	9.1	7.5	8.2	5.5	4.2
Gross borrowing	2.6	5.2	8.9	9.5	7.3	8.0	5.7	4.5
HIPC Initiative relief	0.0	0.0	0.6	0.8	1.5	1.4	1.3	1.0
Amortization repayment (after traditional debt-relief mechanism)	-1.0	-1.2	-1.0	-1.2	-1.3	-1.2	-1.5	-1.2
Domestic(net)	9.6	0.1	0.0	0.4	-0.2	0.9	0.5	0.4
Banking system	10.6	-0.4	-0.7	0.0	-0.8	0.9	0.0	0.0
Nonbank sources	-1.0	0.5	0.7	0.4	0.6	0.0	0.5	0.4
Privatization	1.3	0.8	0.7	0.4	0.6	0.6	0.5	0.0
Float/unidentified financing	-1.0	0.9	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:								
HIPC Initiative relief on interest	0.0	0.0	0.4	0.5	0.7	0.7	0.5	0.5
HIPC Initiative relief on amortization	0.0	0.0	0.2	0.4	0.7	0.6	0.8	0.5

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

1/ Fiscal year ending July 7.
2/ Excluding special programs (demobilization and reconstruction).
3/ Demobilization and reconstruction.

Table 6. Ethiopia: Monetary Survey, 1999/00-2003/04 1/

	1999/00	2000/01	2001/02		2002/03					2003/04
			EBS/02/37	Estimate	EBS/02/37	Revised Program				Revised Program
						Sept.	Dec.	March	July 7	
	(In millions of Birr)									
Net foreign assets (at current exchange rate)	4,783	4,861	6,173	7,659	7,753	7,664	8,461	8,522	9,124	9,918
National Bank of Ethiopia (NBE)	1,929	1,661	2,888	3,908	4,424	3,757	4,526	4,558	4,736	5,259
Assets	2,870	2,857	4,308	5,821	5,977	5,777	6,530	6,672	6,818	7,498
Liabilities	941	1,196	1,419	1,913	1,553	2,020	2,004	2,114	2,083	2,239
Commercial banks	2,854	3,200	3,285	3,751	3,329	3,907	3,935	3,964	4,389	4,659
Of which										
Net claims on Eritrean banks	1,233	1,233	1,233	1,233	1,233	1,233	1,233	1,233	1,233	1,233
Assets	4,957	5,125	5,262	5,698	5,331	5,869	5,911	5,953	6,393	6,684
Of which										
Deposits with Eritrean banks	2,370	2,370	2,370	2,370	2,370	2,370	2,370	2,370	2,370	2,370
Liabilities	2,104	1,925	1,977	1,948	2,003	1,961	1,976	1,990	2,004	2,026
Of which										
Liabilities to Eritrean banks	1,137	1,137	1,137	1,137	1,137	1,137	1,137	1,137	1,137	1,137
Net domestic assets	17,674	19,740	21,153	19,613	22,290	19,971	20,178	21,114	21,539	23,827
Domestic credit	27,114	27,764	29,246	27,567	30,703	27,967	28,415	29,244	29,715	32,105
Claims on government (net) 2/	15,757	15,544	15,123	15,544	14,589	15,544	15,414	15,744	16,044	16,044
NBE	14,000	9,850	9,428	9,202	8,894	9,252	9,272	9,402	9,702	9,702
Commercial banks	1,757	5,695	5,695	6,343	5,695	6,293	6,143	6,343	6,343	6,343
Claims on other sectors	11,357	12,220	14,124	12,023	16,115	12,423	13,000	13,500	13,671	16,060
NBE	394	394	394	394	394	394	394	394	394	394
Commercial banks	10,963	11,826	13,730	11,629	15,721	12,029	12,606	13,106	13,277	15,666
Other items (net)	-9,440	-8,024	-8,094	-7,954	-8,413	-7,996	-8,236	-8,131	-8,176	-8,278
Broad money	22,456	24,598	27,326	27,272	30,042	27,635	28,639	29,635	30,664	33,745
Money	13,265	13,778	15,462	15,224	16,795	14,799	16,099	16,402	17,510	19,091
Currency outside banks	5,923	5,930	6,513	6,851	7,192	6,241	7,739	7,580	7,788	8,908
Demand deposits	7,343	7,848	8,950	8,373	9,603	8,557	8,360	8,822	9,722	10,183
Quasi money	9,191	10,820	11,864	12,048	13,248	12,836	12,540	13,233	13,153	14,654
Savings deposits	8,356	9,824	10,823	10,925	12,023	11,552	11,391	12,020	11,895	13,288
Time deposits	835	996	1,041	1,123	1,225	1,284	1,150	1,213	1,258	1,366
	(Annual change in percent of beginning-period broad money; unless otherwise indicated)									
Net foreign assets	-8.1	0.3	5.3	11.4	5.8	6.9	9.0	8.1	5.4	2.6
Net domestic assets	22.1	9.2	5.7	-0.5	4.2	1.1	4.0	5.5	7.1	7.5
Domestic credit	33.2	2.9	6.0	-0.8	5.3	1.8	5.4	7.8	7.9	7.8
Claims on government (net)	27.9	-0.9	-1.7	0.0	-2.0	0.4	2.7	2.4	1.8	0.0
Claims on other sectors	5.3	3.8	7.7	-0.8	7.3	1.4	2.6	5.4	6.0	7.8
Broad money	14.0	9.5	11.1	10.9	9.9	8.1	13.1	13.7	12.4	10.0
Money	8.2	2.3	6.8	5.9	4.9	2.1	9.4	8.1	8.4	5.2
Quasi money	5.8	7.3	4.2	5.0	5.1	6.1	3.6	5.6	4.1	4.9
Memorandum items:										
Quasi money/broad money (in percent)	40.9	44.0	43.4	44.2	44.1	46.4	43.8	44.7	42.9	43.4
Velocity (GDP/broad money)	2.31	2.11	2.10	1.88	2.09	...	...	...	1.86	1.86
Gross official foreign reserves (in millions of U.S. dollars)	349	337	495	679	678	670	751	762	773	841
Net foreign assets of the banking system (in millions of U.S. dolla	581	574	710	894	880	888	989	1,004	1,035	1,113
Excess reserves (in percent of deposits)	24.5	5.3	6.2	7.8	5.0	9.3	7.0	7.8	7.6	5.1

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

1/ Year ending July 7.
2/ 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 7. Ethiopia: Balance of Payments, 1999/2000-2005/06 1/
(In millions of U.S. dollars, unless otherwise indicated)

	1999/00	2000/01	2001/02		2002/03		2003/04	2004/05	2005/06
			EBS/02/37	Estimate	EBS/02/37	Rev. Prog.	Revised Projections		
Trade balance	-1,125	-1,115	-1,197	-1,229	-1,216	-1,251	-1,278	-1,286	-1,325
Exports of goods	486	441	402	400	442	437	493	572	634
Coffee	262	175	155	156	178	179	205	240	286
Other	224	266	247	244	264	258	288	332	347
Imports of goods	1,611	1,556	1,598	1,629	1,658	1,689	1,771	1,858	1,958
Fuel	250	292	247	246	236	259	263	274	285
Nonfuel	1,361	1,264	1,351	1,383	1,422	1,430	1,507	1,584	1,673
Nonfactor services (net)	149	137	114	114	137	138	167	192	220
Exports of nonfactor services	498	516	494	494	524	525	565	602	641
Imports of nonfactor services	349	387	380	380	387	387	398	410	421
Income (net)	-60	-59	-50	-46	-42	-35	-31	-21	-16
Of which : gross official interest payments 2/	-76	-70	-71	-71	-72	-72	-71	-71	-70
Private transfers (net)	410	379	362	350	393	388	430	458	483
Current account balance, excl. official transfers	-626	-658	-771	-810	-729	-761	-712	-657	-637
(in percent of GDP)	-9.8	-10.5	-11.5	-13.5	-10.2	-11.6	-10.0	-8.5	-7.7
Official transfers (net)	291	395	296	414	288	308	329	348	359
Current account balance, incl. official transfers	-335	-262	-475	-396	-442	-454	-383	-309	-278
(in percent of GDP)	-5.3	-4.2	-7.1	-6.6	-6.2	-6.9	-5.4	-4.0	-3.4
Capital account balance (incl. errors and omissions)	-31	191	516	629	349	458	291	223	220
Foreign direct investment (net)	51	52	40	40	60.0	40	60	70	70
Other investment (net)	101	207	476	462	289	418	231	153	150
Official long-term loans	-10	194	489	474	306	435	247	165	162
Disbursements	182	320	594	569	402	525	348	272	273
Amortization 2/	191	126	105	95	96	90	101	107	111
Other public sector long-term loans (net) 3/	-20	-14	-13	-12	-17	-17	-16	-12	-12
Other (net)	130	26	0	0	0	0	0	0	0
Errors and omissions	-183	-68	0	127	0	0	0	0	0
Overall balance	-366	-71	40	232	-93	5	-92	-86	-58
Financing	366	71	-40	-232	93	-5	92	86	58
Central bank (net; increase -)	44	39	-136	-260	-170	-81	-53	-68	-95
Reserves (increase -)	63	12	-158	-342	-183	-94	-68	-59	-88
Liabilities (increase +)	-19	27	22	81	13	13	15	-9	-7
Fund credit (net)	-12	10	22	38	13	13	15	-9	-7
Disbursement	0	23	36	53	27	27	14	0	0
Repayments	-12	-13	-14	-15	-14	-14	-12	-9	-7
Commercial banks (net; increase -)	181	-26	0	-60	0	-60	-25	0	0
Changes in arrears	40	-810	0	0	0	0	0	0	0
Debt relief (Paris Club II and III, Naples terms, HIPC relief) 4/	101	867	40	89	37	136	18	0	0
Financing gap	0	0	56	0	226	0	152	154	153
Exceptional financing	0	0	17	0	120	0	55	55	55
Traditional debt relief	0	0	0	0	0	0	6	21	20
HIPC relief	0	0	39	0	106	0	91	78	80
Residual gap	0	0	0	0	0	0	0	0	0
Memorandum items:									
Exports of goods (percent change)	0.4	-9.3	-8.9	-9.3	10.1	9.4	12.7	16.0	10.8
Export price index (percent change)	-16.7	-7.8	-9.1	-9.0	2.4	2.0	5.3	7.4	2.6
Export volume index (percent change)	20.5	-1.5	0.2	-0.4	7.5	7.2	7.0	8.0	8.0
Total imports of goods (percent change)	3.4	-3.4	2.6	4.7	3.8	3.7	4.9	4.9	5.4
Import price index (percent change)	25.9	-0.8	-2.7	-2.6	-1.2	-0.3	0.9	0.7	0.9
Import volume index (percent change)	-17.9	-1.9	5.3	7.3	5.0	4.0	4.0	4.2	4.5
Gross official reserves	349	337	495	679	678	773	841	899	987
(in months of imports of goods and nonfactor services of following y	2.2	2.0	2.9	3.9	3.8	4.3	4.4	4.5	4.7
Terms of trade index (1996/97 = 100)	65.6	61.5	57.1	57.4	59.2	58.8	61.4	65.5	66.6
(percent change)	-33.9	-6.3	-6.6	-6.6	3.6	2.3	4.4	6.7	1.7

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

1/ Data pertain to the period July 8-July 7.

2/ Includes debt service to Russia on ruble-denominated debt before up-front discount through 1999/2000; thereafter, after up-front discount.

3/ Ethiopian Airlines and other public enterprises.

4/ Includes 1997 and 2001 Paris Club rescheduling agreements (including Russia) under Naples terms, and 2002 Paris Club topping up to Cologne terms, and HIPC interim relief.

Table 8. Ethiopia: Projected Payments to the Fund, 2002/03-2012/13 1/
(In millions of SDRs, unless otherwise indicated)

	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13
Obligations from existing drawings	12.2	10.0	7.9	6.5	10.2	13.7	13.6	12.1	12.0	6.8	0.3
PRGF/ESAF/SAF repayments	11.4	9.4	7.3	5.9	9.6	13.2	13.2	11.7	11.7	6.5	0.0
Charges and interest 2/	0.7	0.7	0.6	0.6	0.6	0.5	0.4	0.4	0.3	0.3	0.3
On Fund credit	0.5	0.4	0.4	0.4	0.3	0.3	0.2	0.1	0.1	0.0	0.0
On use of SDRs	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Obligations from prospective drawings 3/	0.2	0.1	0.1	0.2	0.2	1.2	5.4	8.5	8.4	8.4	7.3
PRGF/ESAF/SAF repayments	0.0	0.0	0.0	0.0	0.0	1.0	5.2	8.3	8.3	8.3	7.3
Charges and interest 2/	0.2	0.1	0.1	0.2	0.2	0.2	0.1	0.1	0.1	0.0	0.0
On Fund credit	0.2	0.1	0.1	0.2	0.2	0.2	0.1	0.1	0.1	0.0	0.0
On use of SDRs	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total obligations 3/	12.3	10.2	8.1	6.7	10.4	14.9	19.0	20.5	20.4	15.1	7.6
PRGF/ESAF/SAF repayments	11.4	9.4	7.3	5.9	9.6	14.2	18.4	20.1	20.1	14.8	7.3
Charges and interest 2/	0.9	0.8	0.8	0.8	0.7	0.7	0.6	0.5	0.4	0.3	0.3
On Fund credit	0.7	0.6	0.5	0.6	0.5	0.4	0.3	0.2	0.1	0.1	0.0
On use of SDRs	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Outstanding Fund credit 3/ 4/	109.4	120.9	113.5	107.6	98.0	83.8	65.4	45.3	25.3	10.4	3.1
In percent of:											
Exports of goods and nonfactor services	11.8	12.1	10.4	8.9	7.4	5.8	4.2	2.7	1.4	0.5	0.1
External public debt	1.7	1.9	1.7	1.6	1.4	1.2	0.9	0.6	0.4	0.1	0.0
Gross official reserves	19.6	21.0	18.2	16.8	14.0	12.4	9.1	5.9	3.1	1.2	0.3
GDP	2.0	2.2	2.1	2.3	1.7	1.7	1.2	0.8	0.4	0.2	0.0
Quota	81.8	90.4	84.9	80.5	73.3	62.7	48.9	33.9	18.9	7.8	2.3
Total obligations	12.3	10.2	8.1	6.7	10.4	14.9	19.0	20.5	20.4	15.1	7.6
In percent of:											
Exports of goods and nonfactor services	1.3	1.0	0.7	0.6	0.8	1.0	1.2	1.2	1.1	0.8	0.3
External public debt	0.2	0.2	0.1	0.1	0.2	0.2	0.3	0.3	0.3	0.2	0.1
Gross official reserves	2.2	1.8	1.3	1.0	1.5	2.2	2.6	2.7	2.5	1.7	0.8
GDP	0.2	0.2	0.2	0.1	0.2	0.3	0.3	0.3	0.3	0.2	0.1
Quota	9.2	7.6	6.1	5.0	7.8	11.1	14.2	15.4	15.3	11.3	5.7
Memorandum item:											
Projected disbursements	20.9	20.9	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0

Source: Fund staff estimates and projections.

1/ Year ending July 7.
2/ Projections are based on current rates of charge, including burden-sharing charges where applicable, for purchases in the General Resources Account, and on current interest rates for the Enhanced Structural Adjustment Facility (ESAF)/Structural Adjustment Facility (SAF)/Poverty Reduction and Growth Facility (PRGF) and Trust Fund. The current SDR interest rate is assumed for net use of SDRs.
3/ This assumes that the full amount of the new PRGF arrangement (SDR 86.91 million) will be disbursed in seven installments, with each of the first two disbursements amounting to SDR 17 million, and each of the remaining five installments amounting to SDR 10 million. An additional onetime disbursement of SDR 13.37 million (10 percent of quota) has been made at the time of the third disbursement under the PRGF arrangement.
4/ Under assumptions of the medium-term balance of payments projections.

Table 9. Ethiopia: Social Indicators

	Latest Single Year			Sub-Saharan	Low-Income
	1970-75	1980-85	1993-99	Africa	Countries
Population					
Total population, midyear (millions)	33.0	43.4	62.8	642.8	2,417.1
Growth rate (percent; annual average)	2.6	2.8	2.7	2.6	1.9
Urban population (percent of population)	9.5	11.7	17.2	33.8	31.4
Total fertility rate (births per woman)	5.9	7.0	6.3	5.3	3.7
Income					
Gross National Income (GNI) per capita (U.S. dollars)	...	120	100	490	420
Consumer price index (1995=100)	17	51	99	131	138
Food price index (1995=100)	...	52	100	...	...
Income/consumption distribution					
Gini index	...	...	40.0	...	...
Lowest quintile (percent of income or consumption)	...	8.6	7.1	...	...
Highest quintile (percent of income or consumption)	...	41.3	47.7	...	...
Public expenditure					
Health (percent of GDP)	...	...	1.7	1.7	1.2
Education (percent of GNI)	...	3.0	4.0	4.1	3.3
Social security and welfare (percent of GDP)	...	1.4	...	...	...
Net primary school enrollment rate (percent of age group)					
Total	...	29	32	...	...
Male	...	33	40	...	...
Female	...	25	25	...	...
Access to safe water (percent of population)					
Total	...	...	24	55	76
Urban	...	...	77	82	88
Rural	...	...	13	41	70
Immunization rate (percent under 12 months)					
Measles	...	12	53	57	64
DPT	...	6	64	59	70
Life expectancy at birth (years)					
Total	42	44	42	47	59
Male	40	42	41	46	58
Female	43	45	43	48	60
Mortality					
Infant (per thousand live births)	151	143	104	92	77
Under 5 (per thousand live births)	239	213	180	161	116
Adult (15-59)					
Male (per thousand of population)	482	491	567	499	288
Female (per thousand of population)	411	401	523	453	258

Source: World Bank, *World Development Indicators*, 2001.

August 19, 2002

Mr. Horst Köhler
Managing Director
International Monetary Fund
Washington, D.C. 20431

Dear Mr. Köhler:

1. In accordance with the provisions of the three-year arrangement (approved on March 22, 2001) under the Poverty Reduction and Growth Facility (PRGF), the government of Ethiopia, in cooperation with the staff of the International Monetary Fund, has evaluated the implementation of the second annual economic and financial program adopted for the period October 2001–September 2002.[1] We focused on the progress made in implementing the program during the first nine months of the fiscal year 2001/02 and on the prospects and policies to be pursued during the remainder of the program year, in light of the objectives set forth in the memorandum on economic and financial policies for 2001/02, dated December 31, 2001, and the letter dated February 27, 2002. The government intends to make the contents of this letter available to the public and authorizes you to arrange for it to be posted on the IMF website, subsequent to Executive Board completion of the third review under the PRGF arrangement.

2. As you will appreciate, performance under the second annual program has been good, notwithstanding continued deterioration of the terms of trade. All the quantitative performance criteria and benchmarks under the second annual program have been observed (Table 1). Structural performance criteria and benchmarks through March 2002 have also been observed, with the exception of the revised regulation for the provisioning by banks for nonperforming loans and other doubtful assets (benchmark), which has been adopted, but with regard to loan classification is not in line with international best practice as had been envisaged (Table 2). A revision of the directive is to be adopted by August 31, 2002 to bring it closer to international best practice. The government is also determined to meet the remaining performance criteria and benchmarks through September 2002 and the prior actions set in this letter (Table 3). Following the completion of the third review under the PRGF arrangement by the Executive Board, the government requests the fourth disbursement of SDR 10.429 million under the arrangement.

[1] The fiscal year ends on July 7.

3. As envisaged in the memorandum of December 2001, understandings were reached on performance criteria for end-September 2002, in light of the updated budgetary policy framework for 2002/03. Quantitative benchmarks for end-December 2002, as well as indicative targets for end-March 2003, were also established. In addition, in the context of this third review, progress in policy implementation in the financial sector area, particularly to address the weak financial situation of the Commercial Bank of Ethiopia (CBE), was assessed, and a strategy to improve competition in the financial sector was adopted. The government remains committed to implementing all of the policies described in the memorandum of December 31, 2001, the letter dated February 27, 2002, and this letter.

Progress made during the first nine months of 2001/02

4. Considerable progress continues to be made towards restoring peaceful conditions between Ethiopia and Eritrea. To date, Ethiopia has demobilized 140,000 soldiers. On April 13, 2002, an international boundary commission delivered its final and binding ruling on the border between Ethiopia and Eritrea, which was accepted by both countries.

5. As described in the December 2001 memorandum, the second annual PRGF-supported program has been designed in the context of an updated medium-term framework for 2001/02–2003/04 that continues to stress (a) the reorientation of budgetary resources from defense toward poverty alleviation outlays; (b) tax reforms that lay the foundation for strong revenue performance; (c) improved monetary management and financial sector reform; and (d) capacity building and regulatory reforms to promote private sector development. The medium-term objectives for 2001/02-2003/04 set in the December 2001 memorandum are (a) to achieve an annual real GDP growth of about 6 percent; (b) to maintain inflation at a low rate of about 3 percent; and (c) to reduce the external current account deficit (including official transfers) to 4.6 percent of GDP by 2003/04.

6. On the whole, **economic developments** during the first nine months of 2001/02 were satisfactory. Real GDP growth rate for 2001/02 is estimated at 5 percent, lower than the program projection of 5.8 percent. Following the 2000/01 bumper cereal crop, agricultural output is estimated to increase by 4.5 percent in 2001/02, lower than initially projected. Nonagricultural GDP however is still estimated to grow by about 5.5 percent. Coffee exports (which account for 40 percent of merchandise exports) for the first nine months of 2001/02 are estimated at 65,000 tons, compared to a level of 60,800 tons in the same period of 2000/01. However, coffee export prices fell further by 5.8 percent during that period. With the good performance of non-coffee exports, total exports are in line with projections. With much higher food imports than programmed, imports are somewhat higher than projected. A large food surplus led to a 16 percent drop in food prices, resulting in an average annual national consumer price inflation in the first nine months of 2001/02 of negative 9.2 percent as non-food consumer price inflation was 2.4 percent for the same period.

7. The government is greatly concerned by recent declines in producer prices of coffee and cereals. The decline in producer prices of cereals is due to oversupply following the bumper harvest in 2000/01, and large food aid and commercial imports.

However, despite record levels of production and low food prices, Ethiopia will still require food aid in the foreseeable future to help the needy and regions facing shortfalls. In order to reverse the decline in food prices while meeting Ethiopia's food aid requirements, the government is urging donors to increase local purchases of food from food surplus regions. The decline in coffee export prices reflects developments in world markets. The government is taking a number of measures to prop up rural incomes in the medium term. These include measures to encourage crop diversification; to ensure that farmer's production decisions are market driven through better price transmissions; and to enhance rural transport. The authorities intend to conduct a study on the effects of, and ways to reverse or mitigate the impact of, the decline in coffee and cereal prices on producers.

8. **In the fiscal area**, as a result of the accelerated implementation of fully-financed special programs and capital and poverty-targeted expenditure, the program allowed for an increase of the overall budget deficit (including grants and emergency programs) from 5.7 percent of GDP in 2000/01 to 9.1 percent in 2001/02. Overall fiscal performance during the first nine months of 2001/02 has been satisfactory. The government continued to implement its comprehensive tax policy reforms and overhaul its tax administration. A draft value-added tax (VAT) was submitted to Parliament in October 2001, and was ratified in early July 2002 after extensive consultation with the private sector. The large tax payer unit and tax reform implementation task force established in 2001 have been strengthened. During the first nine months of 2001/02, total revenues increased by 10.2 percent compared to 2000/01, and were only slightly lower than projected due to lower direct and indirect tax revenue.

9. On the spending side, the government continued to follow a cautious expenditure management policy. Total expenditure of the general government during the first nine months of 2001/02 was slightly lower than programmed. Capital spending accelerated substantially compared to previous years, in line with the program. The implementation of the emergency programs, projected at 2.2 percent of GDP in 2001/02, has been slightly slower than programmed because of delays in disbursement of external assistance. Defense outlays were also lower, but social spending was in line with the program. The quantitative performance criteria for end-March 2002 on the domestic financing of the government was met with a wide margin.

10. **In the monetary area**, reflecting lower-than-projected economic activity and negative inflation, broad money increased in the first nine months of the year by 5.3 percent, compared to 10.9 percent under the program, and total bank credit fell by 2.3 percent compared to a projected increase by 6.3 percent under the program, partly reflecting increased provisioning by the CBE. During the first nine months of the fiscal year, net claims on the government declined by 2.9 percent, more than programmed. Increased auctions of government securities reduced excess reserves of commercial banks to 3.4 percent of deposits in December 2001, down from 5.3 percent in July 2001. However, excess reserves rose again to 6.9 percent by March 2002. In response to lower economic activity and negative inflation, the NBE lowered the floor on deposit interest rates from 6 percent to 3 percent on March 4, 2002. All banks have adjusted their deposit and lending interest rates accordingly.

11. **Several measures were taken to improve the soundness and competitiveness of the financial sector**, including the issuance of government guarantees for assets held in Eritrea, the issuance of a letter to encourage public entities to do business with all banks, the establishment of a bankers' association, and the lifting of restrictions on the payment of interest on current account deposits. A comprehensive study of the National Bank of Ethiopia's (NBE) operational, organizational, and administrative set-up is being finalized. In line with recommendations under the recent Safeguards Assessment of the NBE, an unqualified audit of NBE's financial statements for the year ended June 30, 2001 was approved by the NBE's Board by end-March 2002. However, delays occurred in bringing to the point of sale the Construction and Business Bank, and in adopting a restructuring plan to address the weak financial condition of the Development Bank of Ethiopia. A workshop was held in Addis Ababa during April 3-4, 2002 to discuss the role of the financial sector in economic development and the issue of competition.

12. With respect to the CBE, which still has over 80 percent of bank deposits and about 70 percent of bank loans, the management contract for the CBE with a foreign bank did not enter into effect as the foreign bank withdrew from the contract in January 2002. At the same time, the Ethiopian anti-corruption commission arrested 28 past and 13 current CBE officials on charges of corruption. Against this background, in March 2002 a new management team that will operate CBE on a commercial basis was appointed. Lending by CBE to customers with loans past due by over one year has been suspended. CBE has also recently increased provisioning from Birr 1.4 billion to Birr 1.9 billion.

13. Significant progress has been made in eliminating most of the previously identified **exchange restrictions**, including the termination of the NBE's weekly wholesale foreign exchange auction and the move of all foreign exchange operations to the interbank market on October 24, 2001. Most trade restrictions and administrative controls on access to foreign exchange were lifted in December 2000. Restrictions on the purchase of foreign exchange for holiday travel and education purposes were eliminated in March 2001. At end-May 2002, the value of the Birr against the dollar had depreciated by 1.1 percent since the beginning of the fiscal year, and net foreign assets of the NBE at end-March 2002 were estimated at US$318.6 million (around 1.8 months of import cover) compared with the programmed US$282.2 million.

14. With respect to **external debt**, the Executive Boards of the IMF and IDA decided that Ethiopia was eligible for assistance and had reached the decision point under the enhanced Initiative for Heavily Indebted Poor Countries (HIPC). All pre-cutoff debt with Paris Club creditors was rescheduled on Cologne terms on April 18, 2002. The performance criteria on the noncontraction of new public or publicly guaranteed nonconcessional debt and on the nonaccumulation of external debt arrears were observed.

15. In other **structural areas**, progress was made, with World Bank assistance, in implementing reforms focused on public sector management, including capacity building, civil service reform and public expenditure policy, and on private sector development. Revised investment and urban land lease laws were adopted. However, the privatization program slowed down and only one public entity was sold in the first nine months of 2001/02 out of the 20 entities put up for sale.

Policies during the remainder of the second annual program

16. Building on the satisfactory results achieved during the first nine months of 2001/02, the government is determined to continue with the steadfast implementation of the program in order to achieve its objectives. A few revisions in the original macroeconomic projections have been made to take into account developments during the first nine months of 2001/02 and measures outlined in this letter. While growth of agricultural output after slowing down to 4.5 percent in 2001/02 would return to a more normal level of about 5 percent, nonagricultural economic activity is expected to continue to grow robustly at around 7 percent as capacity building, infrastructure expansion, the privatization of a number of public enterprises, and further progress in financial sector reform, create an environment conducive to private sector activity. Real GDP growth, estimated at 5 percent in 2001/02, could therefore reach the projected 6 percent in 2002/03. Consumer price inflation is expected to rise to 4.5 percent in 2002/03 on a yearly-average basis. While exports are in line with initial projections, imports are expected to be slightly higher than originally projected. Reflecting these developments, lower nominal GDP,[2] and higher than projected official transfers, the current account deficit (including official transfers) is estimated to be at 6.6 percent of GDP in 2001/02. For 2002/03, the deficit is projected to rise slightly to 6.9 percent as official transfers would return to a more sustainable level.

17. In the **fiscal area**, the government has implemented the measures necessary to limit the overall budget deficit (including grants and emergency programs) in 2001/02 to within the original program target in absolute terms. However, with lower nominal GDP, the deficit for 2001/02 is estimated to reach 9.9 percent of GDP (compared to 9.1 percent under the original program). For 2002/03, the original target of 7.8 percent of GDP was revised upward to 9.7 percent to take into account lower nominal GDP, the identified initial cost of restructuring CBE, and higher-than-initially projected social spending. Based on an expected substantial net recourse to external financing (entirely on concessional terms), net borrowing by the government from the banking system will be limited to Birr 0.5 billion (0.9 percent of GDP). The additional spending to be financed by this bank borrowing includes spending on food security, education, health, and rural development. The government will continue with its cautious spending policy in 2002/03. The Council of Ministers has adopted in June 2002, a budget for fiscal year 2002/03 consistent with the revised fiscal framework presented in this letter. The budget was adopted by Parliament in early July 2002.

18. The government is determined to achieve an increase in tax revenue to 16.6 percent of GDP in 2002/03. To do so, revenue performance will benefit from the introduction of the VAT in January 2003, improved tax administration, especially through the recent strengthening of the large taxpayer unit, and tax arrears collection. The import tariff reform to be introduced by January 2003 is expected to be revenue neutral. The government has taken necessary steps in the preparation for the introduction of the VAT

[2] Nominal GDP is estimated at Birr 51,158 million in 2001/02 and Birr 57,092 million in 2002/03, about 9 percent lower than initially projected under the program.

by January 2003, including the appointment of a program director and the identification of taxpayers. The taxpayer identification number project is to be completed by October 2002. The VAT and income tax laws were passed by Parliament in early July 2002. A poverty and social impact analysis of the VAT will be undertaken by mid-December 2002.

19. On the expenditure side, overall outlays (excluding special programs) are budgeted at 34.6 percent of GDP in 2002/03. Defense outlays will be maintained at the nominal level of the previous year, but as a ratio to GDP will be further cut from 5.9 percent in 2001/02 to 5.3 percent in 2002/03. Poverty-targeted current and capital spending (including on health, education, and priority infrastructure) are to be raised to 18.4 percent of GDP (including 1.4 percent of GDP from HIPC relief) in 2002/03. Capital spending is to be increased, and the wage bill is to be budgeted at Birr 4.455 billion (7.8 percent of GDP). The government will assess by the time of the fourth review under the PRGF the sustainability of possible increased IDA disbursements under the World Bank's forthcoming Country Assistance Strategy. It will include any additional secured commitment from the World Bank and other donors for 2002/03 in a supplementary budget if it is assessed that it will be spent efficiently on poverty-related sectors, and will not jeopardize Ethiopia's external debt sustainability. The government will pursue its efforts to improve its control, tracking and reporting mechanisms of expenditures. In particular, it is determined to consolidate federal and regional budgets for both the past year and the current year, including all extrabudgetary funds and accounts, by end-September 2002. It will also improve the effectiveness, reporting and monitoring of local government expenditures before further decentralizing public spending.

20. In the **monetary and exchange areas**, monetary policy will remain geared toward containing inflation and achieving the international reserve targets. The monetary program for 2002/03 has been updated in light of the revised projections for nominal GDP growth, and with a view to providing room for an adequate increase in credit to the nongovernment sector. The latter will be helped by the government's plan to limit the resort to bank borrowing during the program period. Money supply growth is estimated at 10.9 percent in 2001/02 and is projected at 12.4 percent in 2002/03. With the move of all foreign exchange operations to the interbank foreign exchange market in October 2001, exchange rate policy will continue to be more market-determined.

21. **In the financial sector area**, the government will revise by August 31, 2002 the recently adopted regulation for the provisioning of nonperforming loans and other doubtful assets to bring it more in line with international best practices, by including five categories for the classification of nonperforming loans, and removing any temporary weakening of provisioning that may result from the phasing in of the new requirements that will be fully implemented by January 2004. With regard to the inclusion of borrowers' repayment capacity as a criterion for the classification of nonperforming loans, the authorities believe that in the absence of reliable and timely financial information on borrowers, it would not be advisable at this time to require banks to have an assessment of repayment capacity of their clients on a subjective basis. The authorities will nonetheless encourage banks to use available information to assess repayment capacity of borrowers. Once the quality and timeliness of financial information of clients improves, the authorities will revise the guidelines accordingly. The government will also

(a) take steps to strengthen the NBE, following the completion of the ongoing comprehensive study of the NBE, including as necessary, revising the existing Banking Act to increase the NBE's autonomy by end-December 2002; (b) ensure that the Construction and Business Bank is brought to the point of sale after its balance sheet has been restructured on the basis of NBE's recommendations, by end-December 2002; and (c) adopt a restructuring plan to address the weak financial condition of the Development Bank of Ethiopia by end-September 2002.

22. **With respect to the CBE,** a performance contract was signed between the government and the new CBE management on June 28, 2002 to ensure that CBE is operated effectively on a commercial basis so as to achieve the necessary improvements in financial performance. At the same time, the credit approval and monitoring process was strengthened, lending authority was transferred from the Board of CBE to its management, and an audit committee was created at the Board to oversee financial performance. The new management will have autonomy in decision-making including on staffing, meeting performance targets, pursuing delinquent borrowers, as well as on taking steps to strengthen CBE's cost competitiveness and profitability. CBE will also (a) hire consultants from a reputable foreign financial institution by end-September 2002 to assist the new management; (b) strictly adhere to the reserve requirement, and fully implement the new provisioning directive; (c) reduce nonperforming loans (NPLs) by Birr 0.8 billion from Birr 3.9 billion at end-December 2001, including through write-offs, by end-September 2002; and (d) prepare a financial restructuring plan until end-March 2003, on the basis of a financial audit of the CBE to be conducted by an internationally reputable audit firm. The terms of reference for this audit was tendered on July 13, 2002, and the audit completed by end-January 2003. The restructuring plan will seek significant reduction of NPLs, including through write-offs, and the recapitalization of CBE on a timely basis. All options for the restructuring of CBE will be kept open. The investigation related to the arrest of CBE's managers on corruption charges is continuing.

23. The government will continue its efforts to enhance efficiency and competition in the financial sector, to prepare the ground for the progressive integration of the Ethiopian financial sector into the global financial market. Efforts are being made to strengthen private and public banks through creating a favorable external environment for banking, strengthening the internal dynamics of banks, and fostering contestability of markets within the banking sector. Measures were taken in early July 2002 to enforce the foreclosure law effectively and expeditiously to allow banks to reduce nonperforming loans and deter delinquency in loan repayments. Banks will be encouraged to modernize and raise efficiency by adopting improved practices and building their capacities, through a rigorous application of the revised bank provisioning directive, and more autonomous bank management, that is made more accountable to its board of directors. To enhance competition, private banks will be encouraged to increase their scale of operation, and raise their capital base, including through mergers. The government will also foster the development of microfinancing institutions, by transforming them into rural banks, as has already began, and by facilitating the flow of funds from commercial banks to these institutions for purposes of onward lending.

24. **In the external sector area**, as noted earlier, the current account deficit (including official transfers) is projected at 6.9 percent of GDP in 2002/03. It is expected

that much of the demobilization, reconstruction, and sector development efforts will continue to be fully funded by multilateral and bilateral donors. The balance of payments is also to benefit from recent Paris Club rescheduling agreement. The reserve cover is to increase from 3.9 months of imports at end-2001/02 to 4.3 at end-2002/03.

25. Following the Paris Club meetings on April 5, 2001 and April 12, 2002, the government will finalize bilateral agreements by end-October 2002, and seek at least comparable terms from its non-Paris Club creditors, by December 31, 2002.

26. The government will reduce, by January 2003, the average (non-weighted) import tariff from an existing level of 19½ percent to 17½ percent, by lowering the maximum tariff and reducing the number of bands, and eliminating most tax and duty exemptions, to minimize any negative impact of the trade reform on government revenues. The authorities are considering reducing the maximum tariff from 40 percent to 35 percent, and the number of bands from 7 to 5. There are no remaining nontariff barriers with the exception of bans on imports of opium, ethyl alcohol and other spirits denatured of any strength, worn clothing and worn textile articles, and rags.

27. The government will continue to implement the recommendations of the Safeguards Assessment by end-December 2002, with technical assistance from the Fund. All differences older than six months on the foreign correspondent bank accounts will be reconciled, and steps will be taken to ensure that NBE's accounting records properly reflect the balances held with foreign correspondent banks.

28. On other **structural reforms**, the government, in consultation with the World Bank, will continue to implement key structural measures needed for enhancing the economy's growth potential and reducing poverty. Understandings have been reached with the World Bank on an Economic Structural Adjustment Credit focusing on public sector management, including civil service reform, public expenditure policy, private sector development, and export competitiveness. The authorities are also strengthening the existing legal and regulatory framework and taking measures to accelerate the privatization program that aims at bringing to the point of sale another 38 public entities (including units of whole enterprises) in 2002/03. With the assistance of MIGA, the authorities are also working to settle expropriation claims in the near future. The government will finalize by end-July 2002 the **full PRSP**, and submit it to the Executive Boards of the IMF and IDA. Wide-ranging consultations at the district, regional, and federal levels were completed in March 2002.

29. **Efforts to improve statistics** will be intensified, particularly the reporting of data on a timely basis, including by fully staffing the fiscal policy, national accounts, and accounting departments of the Ministry of Finance and Economic Development. The authorities will reconcile monetary and fiscal accounts by end-December 2002; the initial date of September 2002 is no longer feasible in view of the needed technical assistance, which is being provided by the IMF. They will continue to implement the recommendations of recent missions from the IMF's Statistics Department, including the revision of monetary statistics and the coverage of international reserves. The authorities will continue to improve data on poverty and social indicators, with a view to monitoring the output and outcomes of poverty reduction programs. Ethiopia will also participate in

the General Data Dissemination System (GDDS) in 2002/03 and towards this end it has appointed a national coordinator.

30. The government believes that the reforms and measures set forth in this letter and in the letter and memorandum on economic and financial policies of December 31, 2001, and the letter dated February 27, 2002 are adequate to achieve the revised objectives of the second annual program. As envisaged, a fourth review, to be completed by December 20, 2002, will assess progress in policy implementation and describe the third annual program for the period October 2002–September 2003, and set performance criteria and benchmarks through June 2003.

Sincerely yours,

/ s /	/ s /
Sufian Ahmed Minister of Finance and Economic Development	Teklewold Atnafu Governor of the National Bank of Ethiopia

Attachments (3)
Quantitative Benchmarks and Performance Criteria
Structural Benchmarks and Performance Criteria
Prior actions

Table 1. Ethiopia: Quantitative Benchmarks and Performance Criteria for the Second Annual Program Supported by the PRGF Arrangement, October 2001-March 2003 1/
(In millions of birr, unless otherwise indicated)

	2001						2002								2003
	July 7	September	December				March				July 7	September		December	March
	Actual (Stock)	Actual 2/	Benchmark	Revised Benchmark	Adjusted Benchmark	Actual	Indicative Target	Perf. Crit. 3/	Adjusted Perf. Crit.	Actual	Benchmark	Indicative Targets	Perf. Crit. 4/	Benchmark 5/	Indicative Targets 6/
I. Quantitative benchmarks and performance criteria															
Floor on net foreign assets of the National Bank of Ethiopia 7/ 8/	1,672	704	253	427	345	562	317	734	306	1,044	1,159	1,230	-177	551	551
Ceiling on net domestic assets of the National Bank of Ethiopia 9/ 10/	7,361	24	-90	-158	-75	-933	-190	-225	203	-321	-334	-371	163	199	446
Ceiling on net domestic financing of the general government (incl. privatization receipts) 10/ 11/ 12/	17,313	-1,210	400	-280	-198	-1,259	500	0	428	-796	400	-371	0	-280	400
Ceiling on outstanding external payments arrears (in million of US$) 13/	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Ceiling on new nonconcessional external debt contracted or guaranteed by the public sector 14/	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
II. Indicative target															
Floor on net foreign liquid reserves of the National Bank of Ethiopia 7/ 8/	1,193	710	253	433	351	562	317	740	312	1,138	1,159	1,230	-177	551	551
III. Triggers for adjustment of quantitative benchmark and performance criteria															
Disbursed nonproject external funding (in million of U.S. dollars) 15/	0	150	179	179	160	160	247	329	210	210	423	168	42	200	259

Source: Ethiopian authorities.

1/ For 2001/02, cumulative flows from July 8, 2001. For 2002/03, cumulative flows from July 8, 2002. Program exchange rate of 8.524 Birr/USD used.
2/ September 2001 calculations are based on the previous program exchange rate of 8.255 Birr/USD.
3/ Established as performance criterion in the context of the second review.
4/ Established as performance criteria in the context of the third review.
5/ Established as benchmarks in the context of the third review.
6/ To be established as performance criteria in the context of the fourth review.
7/ Adjusted upward for external assistance (nonproject, excluding enhanced HIPC interim assistance) that exceeds programmed amounts (paragraph 12 of the Technical Memorandum (TM) dated December 2001).
8/ Adjusted downward for 50 percent of any shortfall in programmed external assistance (nonproject, excluding enhanced HIPC interim assistance) up to a maximum of US$50 million (done for December 2001 and March 2002; paragraph 15 of the TM dated December
9/ Adjusted downward for external assistance (nonproject, excluding enhanced HIPC interim assistance) that exceeds programmed amounts (paragraph 13 of the TM dated December 2001).
10/ Adjusted upward for 50 percent of any shortfall in programmed external assistance (nonproject, excluding enhanced HIPC interim assistance) up to a maximum of US$50 million (done for December 2001 and March 2002; paragraph 15 of the TM dated December 2
11/ Adjusted downward for external assistance (nonproject, excluding enhanced HIPC interim assistance) that exceeds programmed amounts (paragraph 14 of the TM dated December 2001).
12/ Stock at July 7, 2001 reflects domestic government borrowing, but excludes privatization receipts.
13/ There shall be a continuous performance criterion on the nonaccumulation of new external arrears.
14/ This limit applies not only to debt as defined in Point No. 9 of the Guidelines on Performance Criteria with Respect to Foreign Debt, adopted by the IMF on August 24, 2000, but also to commitments contracted or guaranteed for which the value has not b
Excluded from this limit are short-term import credits and long-term financing operations of Ethiopian Airlines.
15/ Excluding fertilizer projects.

Table 2. Ethiopia: Structural Benchmarks and Performance Criteria Under the Second Annual Program Supported by the Three-Year PRGF Arrangement

Structural Benchmarks and Performance Criteria	Timing
Adopt regulation for the provisioning by banks for nonperforming loans and other doubtful assets in line with international best practices, taking into account Basel Committee guidelines for troubled debt restructuring and credit risk.	March 31, 2002 1/ (benchmark)
Submit to the NBE's Board an unqualified audit of NBE's financial statements carried out by the Audit Services Corporation for the year ended June 30, 2001.	March 31, 2002 (done) (performance criterion)
Sign a performance contract with CBE to ensure that CBE is operated effectively on a commercial basis to achieve the necessary improvements in financial performance.	June 30, 3002 (done) (benchmark)
Reduce nonperforming loans of the CBE by Birr 0.8 billion (from Birr 3.9 billion at end-December 2001), including through write-offs.	September 30, 2002 (benchmark)
Consolidate federal and regional budgets for both the past year and the budget year—including all extrabudgetary funds and accounts.	September 30, 2002 (benchmark)
Reconcile monetary and fiscal accounts.	December 31, 2002 (revised) 2/ (benchmark)
Introduce the value-added tax, as adopted by Parliament on July 4, 2002.	January 1, 2003 (performance criterion)
Complete the audit of the CBE by a reputable international audit firm.	January 31, 2003 (benchmark)

1/ Regulation adopted; but needs to be revised by August 31, 2002 to bring it more in line with international best practice.

2/ Initial date was September 30, 2002.

Table 3. Ethiopia: Prior Actions for the Completion of the Third Review
Under the Three-Year PRGF Arrangement

Prior Actions	Timing
Adoption by the Council of Ministers of a budget for fiscal year 2002/03 consistent with the revised fiscal framework presented in the letter of intent.	June 30, 2002 (done)
Tendering the financial audit of the CBE to internationally reputable audit firm.	July 15, 2002 (done)
Revision of the recently adopted regulation for the provisioning by banks for nonperforming loans and other doubtful assets to bring it more in line with international best practice, by including five categories for the classification of nonperforming loans, and removing any temporary weakening of provisioning that may result from the phasing in of the new requirements.	August 31, 2002

Ethiopia: Relations with the Fund

(As of June 30, 2002)

I. Membership Status: Joined 12/271945; Article XIV

II. General Resources Account	**SDR Million**	**Percent of quota**
Quota	133.70	100.00
Fund Holdings of Currency	126.55	94.66
Reserve position in Fund	7.17	5.36

III. SDR Department	**SDR Million**	**Percent of allocation**
Net cumulative allocation	11.16	100.00
Holdings	0.23	2.04

IV. Outstanding Purchases and Loans	**SDR Million**	**Percent of quota**
Structural Adjustment Facility (SAF)	14.83	11.09
Enhanced Structural Adjustment Facility (ESAF) and Poverty Reduction and Growth Facility (PRGF)	86.58	64.75

V. Latest Financial Arrangements

Type	Approval Date	Expiration Date	Amount Approved (SDR million)	Amount Drawn (SDR million)
PRGF	03/22/2001	03/21/2004	100.28	58.56
ESAF	10/11/1996	10/22/1999	88.47	29.49
SAF	10/28/1992	11/08/1995	49.42	49.42

VI. Projected Obligations to Fund Under the Repurchase Expectations Schedule

	Forthcoming; in SDR million				
	2002	2003	2004	2005	2006
Principal	6.4	10.0	8.7	5.9	7.6
Charges/interest	0.6	0.7	0.7	0.6	0.6
Total	7.0	10.7	9.4	6.5	8.2

VII. Implementation of HIPC Initiative

Commitment of HIPC assistance	Enhanced Framework
Decision point date	Nov 2001
Assistance committed (NPV terms)[1]	end-2000/01

[1]NPV terms at the decision point under the enhanced framework.

Total asistance by all creditors (US$ Million)	1,275
Of which: IMF Assistance (SDR Million)	26.93
Completion point date	Floating
Delivery of Fund assistance (SDR Million)	
Amount disbursed	4.04
Interim assistance	4.04
Completion point	0.00
Amount applied against member's obligations (cumulative)	3.04

VIII. Safeguards Assessment

Under the Fund's safeguards assessment policy, the National Bank of Ethiopia (NBE) is subject to a full safeguards assessment with respect to the Poverty Reduction and Growth Facility arrangement approved on March 22, 2001, which is scheduled to expire on March 21, 2004. An off-site safeguards assessment of NBE was completed on May 4, 2001. The assessment concluded that high risks may exist in financial reporting and in the system of internal controls and recommended an on-site assessment. The on-site assessment was completed on September 12, 2001. The staff's findings and recommendations are reported in Appendix V of EBS/02/37 (3/4/02).

IX. Exchange Rate Arrangement

Effective October 24, 2001, NBE terminated the weekly wholesale foreign exchange auctions for the birr (Br) and moved all foreign exchange operations to the interbank market. The transaction-weighted average interbank market exchange rate on June 19, 2002 was Br 8.5657 = US$1.

In March 2001, the authorities eliminated previously existing restrictions on the purchase of foreign exchange for holiday travel and education purposes. Since then, exporters have been allowed to retain 10 percent of their export proceeds in foreign exchange for an indefinite period. The rest may be retained for a period of 28 days, after which it has to be converted into local currency by the customer's bank using the prevailing transaction rate, unless an exporter spends it on eligible imports within 28 days. The multiple currency practice that might have arisen from the NBE's weekly foreign exchange auction was lifted with the replacement of the auction by the interbank foreign exchange market. However, a few current account exchange restrictions remain with respect to Article VIII, Sections 2, 3, and 4 of the IMF's Articles of Agreement.

X. Article IV Consultation

Ethiopia is on the 24-month cycle for members with Fund arrangements. At the conclusion of the 2000 Article IV consultation discussions on March 19, 2001 (EBM/01/28), the Executive Board adopted the following decision:

1. The Fund takes this decision relating to Ethiopia's exchange measures subject to Article VIII, Section 3, in light of the 2000 Article IV consultation with Ethiopia conducted under Decision 5392-(77/63), adopted April 29, 1977, as amended (Surveillance over Exchange Rate Policies).

2. Ethiopia maintains a multiple currency practice arising from a spread of more than two percent between different buying rates at the weekly wholesale foreign exchange auctions conducted by the National Bank of Ethiopia, which is subject to approval under Article VIII, Section 3. In the circumstances of Ethiopia, the Fund grants approval of the retention of this multiple currency practice until October 1, 2001 or the conclusion of the next Article IV consultation with Ethiopia, whichever is earlier.

XI. Technical Assistance (2000-present)

Department	Purpose	Time of Delivery
FAD	Tax administration (resident expert)	May 1999-July 2001
STA	Consumer price index	March-April 2000
FAD	Introduction of VAT, presumptive income tax, and reform of the income tax	August 2000
FAD	Tax administration	October 2000
MAE	Monetary and banking reforms	October 2000
FAD/LEG	Tax administration and VAT legislation	January-February 2001
MAE	Monetary and banking reforms	February-March 2001
FAD	Tax administration	April 2001
MAE	Bank supervision	April-May 2001
MAE	Monetary and banking reforms	May 2001
MAE	Interbank foreign exchange market	June-July 2001
LEG	Income tax legislation	September 2001
FAD	Tax administration	September-November 2001
MAE	Bank supervision	September-October 2001
LEG	Review of compliance with Article VIII	November 2001
STA	Consumer price index	November-December 2001
STA	Multisector	January 2002
MAE	Bank supervision	February 2002
FAD	Tax administration	February 2002
STA	Fiscal and monetary accounts	May 2002
LEG	VAT law	May 2002
FAD	Public expenditure management	July 2002
FAD	Tax administration	July 2002

XII. Resident Representative

Mr. Alexander Kyei assumed the post in August 2001.

Ethiopia: Relations with the World Bank
(As of June 2002)

Bank Group Strategy

The government of Ethiopia is finalizing its Poverty Reduction Strategy Paper (PRSP). In parallel with the PRSP, the World Bank is preparing its Country Assistance Strategy (CAS) for 2002/03-2004/05 (July 8-July 7) in a consultative manner with the Government and other stakeholders, and in alignment with PRSP objectives. As part of the consultation process, extensive discussions have already occurred in workshops addressing three themes (capacity building in March 2002; decentralization and service delivery in May 2002; and private sector development and pro-poor growth in July 2002). The criteria that are informing the CAS are (a) the government's strategy, as defined in the PRSP; (b) the macroeconomic framework, as defined in the PRGF arrangement/HIPC; (c) the Bank Group's comparative advantage by way of experience and expertise; (d) lessons learnt from the past; and (e) the programs of other development partners.

Bank assistance to Ethiopia has largely been through the traditional project mechanism. Over the last five years, Bank-piloted Sector Development Programs (SDPs) in health, education, and roads have represented a major and continuing innovation in donor support and coordination. Following the end of the border conflict between Ethiopia and Eritrea, the Bank provided support through emergency operations. The Ethiopia Structural Adjustment Credit (ESAC) was approved for an amount of US$120 million on June 18, 2002. Meanwhile, the Bank has designed new instruments, such as Adjustable Program Lending (APL) and Poverty Reduction Support Credits (PRSC), and has extended the funds approach to other sectors. The CAS will identify the most appropriate mix of lending instruments and knowledge agenda to support the government in implementing its PRSP.

At the start of 2002/03, Ethiopia's portfolio of IDA credits comprised 18 active projects, with total commitments of US$1,725.7 million and an undisbursed balance of US$911.5 million. This total is up from 14 projects, commitments of US$1,382 million, and an undisbursed amount of US$946 million at the beginning of 1999/2000.

Strategic Priority Areas

The overarching goal of Bank strategy will be to support the government's strategy for growth and poverty reduction. In preparing the CAS, we will identify opportunities to support the government's strategy around several strategic priority areas that reinforce one another to raise growth, productivity, and the effectiveness of policy:

- capacity building;
- decentralization and service delivery; and
- private sector development (PSD)

The CAS will also assign particular importance to infrastructure development. While the details are being finalized, the strategic priority areas are expected to take shape along the following lines.

- **Capacity building.** In October 2001, the government unveiled a comprehensive five-year National Capacity Building Program (NCBP), comprising 14 components, to rapidly build capacity in support of second-generation reforms aimed at promoting pro-poor growth, deepening democratic decentralization, and improving service delivery at the national, regional, and local levels. The Bank is supporting the government program with a pilot activity on public sector capacity building for decentralization, and plans to scale this up in the shape of a Public Service Delivery and Capacity Building Program (PSCAP) over the CAS period.

- **Decentralization and service delivery.** The government views decentralization as the principal means to achieving its poverty reduction objectives and has accordingly made a strategic choice in further deepening the process of decentralization by granting greater responsibility to the subnational governments for primary education, primary health, rural water, and rural roads, and by allocating untied block grants to *woredas*.

- The Bank's recent work on decentralization by way of the Regionalization Study, Woreda Studies and the annual public expenditure reviews (PERs) suggests the need for strengthening the institutions and systems of decentralization in terms of capacity, participation, and public expenditure management. In the context of CAS/PRSP preparation, the Bank is determining the appropriate instruments to support decentralization, which could include Poverty Reduction Support Credits (PRSC) and traditional projects, or sector investment programs.

- **Private sector development.** The Bank is working with the government to identify and implement actions to support the growth of a value-creating market economy through a partnership to identify and resolve obstacles to private sector development. The government has committed itself to enhancing transparency by tax reform, judicial reform, civil service reform, and other means. The regulatory regime is being refined, with a view to fairness and efficiency, and minimizing distortions. Capacity-building efforts will be directed at both the public and private sectors. Workable, programmatic solutions will be implemented systematically to improve the investment climate and encourage both domestic and foreign private investment. Support is also being provided to develop the country's infrastructure through the Road Sector Development Program Project, a Roads Rehabilitation Project, a Water Supply Development and Rehabilitation Project, and the Ethiopia Energy II Project. It is expected that an Energy Access Project will be presented to the Board in early 2002/03. The CAS under preparation for 2002/03-2004/05 will identify opportunities to assist the government in the provision of infrastructure where it is a pure public good, and to help create an enabling environment for greater private participation in infrastructure provision.

Bank-Fund Collaboration in Specific Areas

Preparation of the PRSP. The World Bank and the IMF have collaborated in providing support to the government in the preparation of the PRSP, including by preparing joint comments on an early draft of the PRSP, and they will work together on the preparation of the joint staff assessment.

As part of its overall assistance to Ethiopia—through lending and analytical work—the Bank and the Fund jointly support policy reforms in a number of areas, including the following main areas:

- **Macroeconomic policy**. There was close cooperation between the World Bank and the IMF in discussing macroeconomic policy with the government. Complementing the PRGF arrangement, the Bank's Ethiopia Structural Adjustment Credit (ESAC) focuses on economy-wide reforms in support of the government's pro-poor growth strategy, with the objectives of (a) maintaining macroeconomic stability and increasing growth; (b) strengthening markets and institutions, including measures to improve the international competitiveness of the economy through liberal import, foreign direct investment, and foreign exchange and credit regimes; (c) deepening civil service and decentralization reforms, in order to enhance public accountability and empower communities to improve the quality of service delivery; and (d) strengthening public expenditure management, so as to improve the quality of public service delivery.

- **Financial sector.** The Bank has been an active participant in the Fund-led dialogue with the government on financial sector reforms, particularly in reviewing rural financing, options to reform CBE, and conditions to enhance competition in the financial sector, including foreign bank entry.

- **Public expenditure management.** The Fund has been an active participant in the Bank-coordinated annual public expenditure reviews, which have provided an important avenue for an objective analysis of the government's public expenditure strategy, as well as an opportunity to study issues in public finance management of common interest and concern. The 2001 PER was the first review of public expenditure at the regional level. The 2002 PER will focus on (a) spending in the social sectors; and (b) regional issues, particularly subregional transfers in the context of the ongoing process of deepening decentralization.

- **Statistical issues.** Both institutions have been providing technical assistance to the government of Ethiopia on the compilation of data and statistics, with the Fund focusing on the compilation of macroeconomic statistics and the Bank supporting the improvement of data on poverty and social indicators, and on the monitoring of output and outcomes of poverty reduction programs.

- **The enhanced HIPC Initiative.** In the context of the HIPC decision point (November 2001), the government agreed with IDA and the IMF on a system for tracking the use of savings arising from HIPC interim assistance.

Ethiopia: Relations with the World Bank Group
(As of July 12, 2002; in millions of U.S. dollars)

A. Statement of IBRD Loans and IDA Credits

Project ID	Fiscal Year	Borrower/Purpose	IDA	Undisbursed	Cancellations
Closed projects: 63					
P000733	1998	AG. RESEARC & TRAIN	60.0	36.8	
P052315	2001	CONSERVATION OF MEDICINAL PLANTS	2.6	2.5	
P057770	2002	CULTURAL HERITAGE	5.0	5.0	
P073196	2001	Demobilization and Reintegration Project	170.6	72.0	
P000732	1998	EDUCATION SECTOR INVESTMENT	100.0	32.2	
P067084	2001	EMERGENCY RECOVERY AND REHAB. PROJECT	230.0	162.4	
P000736	1998	ET ENERGY II	200.0	89.9	
P069886	2001	ETHIOPIA MULTISECTORAL HIV/AIDS PROJECT	59.7	47.8	
P074585	2002	Ethiopia Structural Adjustment Credit	120.0	120.0	
P050383	2002	FOOD SECURITY PROJECT	85.0	85.0	
P069083	2001	GLOBAL DISTANCE LEARNING	4.9	4.9	
P000756	1999	HEALTH SECTOR	100.0	51.0	
P000752	1995	NATIONAL SEEDS PROJECT	22.0	3.8	4.2
P000734	1993	ROAD REHABILITATION	96.0	14.7	
P000755	1998	ROAD SEC. DEV. PROG.	309.2	155.1	
P000771	1996	Social Rehab (ESRDF I)	120.0	16.1	11.5
P000764	1996	WATER SUPPLY DEV&REH	35.7	7.8	
P050342	2001	WOMEN'S DEVELOPMENT INITIATIVES PROJECT	5.0	4.6	
Total for 18 active credits			1,725.7	911.5	15.7

B. Statement of IFC Investments

Year	Borrower/Purpose	Original Gross Commitments			Total
		Loan	Equity	Participant	
Fully canceled, terminated, written-off, sold, redeemed, or repaid investments					
1965-73	Dire Dawa (Spinning, weaving and finishing)	2.4	1.4	1.1	4.8
1966	Ethiopian Pulp (Manuf. of pulp paper and paperboard)	0.0	1.9	0.0	1.9
1968	Metahara (Sugar factories and refineries)	4.9	3.5	0.7	9.0
1989	Red Sea (Crude petroleum and natural gas)	0.0	7.8	0.0	7.8
Approvals pending commitment					
2002	Coca-Cola SABCO (Ethiopia, Kenya, Uganda, Tanzania, and Mozambique)	15.0	10.0	0.0	25.0
Total gross commitments 1/		22.3	24.6	1.7	48.6
Less: cancellations, terminations, repayments and sales		7.3	14.6	1.7	23.6
Total commitments now held		15.0	10.0	0.0	25.0

Source: World Bank.

1/ Gross commitments consist of approved and signed projects.

Ethiopia: Statistical Issues

Real sector

1. The authorities have improved the timeliness and coverage of national accounts, economic surveys, and prices since 1993. Preliminary national accounts are available through 2000/01 (July 8-July 7). Data on sectoral deflators had not been compiled as of end-June 2002. A new series of GDP estimates, using a 1995/96 base period, is under construction and is expected to be released shortly, but it will need to be updated again since the base period will be seven years out of date. With the assistance of a number of STA missions, a new consumer price index (CPI) has recently been released, consisting of a national index and 11 regional indices, which have replaced the old urban and rural indices. In addition, the base period has been updated to December 2000, using data from the Household Income, Consumption, and Expenditure Survey of 1999/2000.

Public finances

2. Monthly federal government accounts are reported with a six- to eight-week lag. The consolidated general government (federal and regional) accounts are reported once a year. The ongoing devolution of budgetary authority to regional governments has further eroded the quality of the general government accounts, owing to the lack of a unified accounting framework. The coverage of government finance statistics is incomplete (it excludes extrabudgetary funds, namely, the privatization, road, fuel stabilization, and sugar auction funds), and there are discrepancies between data on the domestic and foreign financing of the budget deficit and the monetary accounts. The Ministry of Finance and the National Bank of Ethiopia (NBE) established a joint reconciliation committee, which issued a set of recommendations to synchronize the recording of fiscal and monetary data, broaden the scope of institutional coverage, and improve the classification of accounts.

Monetary accounts

3. The monetary survey is comprehensive and normally reported with a six-week lag. An STA technical assistance mission in January 2002 found that Ethiopia's money and banking statistics are broadly adequate for policy and analytical purposes, although their quality is compromised by various methodological problems. The mission recommended correcting classification problems in the resident sector and with the accounting data and establishing a separate identification of nonperforming assets. Regarding international reserves, the mission recommended that the NBE limit its coverage to liquid foreign assets only. Finally, based on its examination of the draft version of the new report form, the mission recommended that the NBE introduce the new report form without delay.

Balance of payments

4. Balance of payments data still require improvements in the coverage, valuation, timing, and classification of transactions. The authorities have begun working toward the adoption of the fifth edition of the *Balance of Payments Manual*, but problems persist. In particular, key surveys recommended by the 1995 STA mission for the collection of basic data were not carried out until early 1999/2000. Import data still rely primarily on exchange control data, even though the quality of that data has worsened in the wake of the exchange system liberalization in 1998. The use of customs records to generate trade data has begun with the operationalization of the Automated System for Customs Data (ASYCUDA) at major customs stations in February 1999, which should improve the timeliness and coverage of trade statistics. An export unit value index is available (with a two-year delay), but no import unit value index is produced. Data on official and private transfers and private capital flows are also weak. The NBE, in collaboration with the Ethiopia Investment Authority and other government agencies, is preparing a database on foreign direct investment, including a reporting system for tracking new investment. The January 2002 multisector mission recommended methods for the improvement of data on tourism, insurance, foreign direct investment, private transfers, and private debt.

Social indicators

5. Data on poverty exist in the form of several household surveys regularly conducted by the Central Statistical Authority (CSA).[1] In addition, the World Bank has produced reports on Education and Health Sector Development Programs, as well as the Poverty and Policies for the New Millennium Report (1999), that contain data on the poverty situation in Ethiopia. On the basis of this information, the government, with assistance from the World Bank, has constructed welfare indicators for measuring poverty reduction, including income and expenditure per capita, income inequality, literacy, malnutrition, and infant/child mortality measures. Adequate data do not exist on prevalence rates of HIV/AIDS, especially among the rural population, and it is not clear whether there is sufficient monitoring of food consumption among people living in drought-prone areas.

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[1] Examples of existing surveys include the Household Income, Consumption, and Expenditure Survey (1995/96 and 1999/2000) and the Welfare Monitoring Survey (1996, 1997, 1998, and 1999). Additional household and consumption surveys were carried out by the University of Addis Ababa in collaboration with Oxford University, but they are not currently available to the public or Fund staff.

Ethiopia: Survey of Reporting of Main Statistical Indicators
(As of July 23, 2002)

	Exchange Rates	Net Foreign Assets of the Banking System	Reserve/ Base Money	Central Bank Balance Sheet	Broad Money	Interest Rates[1]	Consumer Price Index (CPI)[2]	Exports and Imports[3]	Current Account Balance	Overall Federal Government Balance	GDP	External Debt/Debt Service
Date of latest observation	June 19, 2002	May 2002	May 2002	May 2002	May 2002	April 2002	March 2002	March 2002	March 2002	March 2002	2000/01	March 2002
Date received	June 20, 2002	July 2002	July 2002	July 2002	July 2002	July 2002	June 2002	May 2002	May 2002	May 2002	November 2001	May 2002
Frequency of data	Daily	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Quarterly	Quarterly	Monthly	Annual	Quarterly
Frequency of reporting	Daily	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Quarterly	Quarterly	Monthly	On mission	On mission
Source of data	National Bank of Ethiopia	National Bank of Ethiopia	National Bank of Ethiopia	National Bank of Ethiopia	National Bank of Ethiopia	National Bank of Ethiopia	Central Statistical Authority	National Bank of Ethiopia	National Bank of Ethiopia	Ministry of Finance	Ministry of Finance and Economic Development	Ministry of Finance and Economic Development
Mode of reporting	Fax	Fax	Fax	Fax	Fax	Fax	Fax	On mission	On mission	Fax	On mission	On mission
Frequency of publication	Daily	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Quarterly	Quarterly	Annually	Annually	Irregularly
Confidential	No	No	No	No	No	No	No	No	No	No	No	No

[1] Savings and time deposits and lending rates. Yields on treasury bills at the auction are reported every two weeks, with the latest data as of June 12, 2002.
[2] National CPI only. For Addis Ababa CPI, the latest observation is April 2002 (received June 2002).
[3] Export and import data are based on customs records.

Statement by the IMF Representative
September 23, 2002

1. Additional information has become available since the issuance of the staff report for the 2002 Article IV Consultation and Third Review Under the Poverty Reduction and Growth Facility Arrangement (EBS/02/158). The information does not change the thrust of the staff appraisal.

2. As indicated in the letter of intent of August 19, 2002 and in Table 3 presented in Appendix I of the Staff Report for the 2002 Article IV Consultation and Third Review Under the Poverty Reduction and Growth Facility Arrangement, the first two prior actions were completed before the report was issued to the Executive Board on August 21, 2002. The third prior action was completed as scheduled on August 31, 2002. The prior actions included (i) the adoption by the Council of Ministers of a budget for fiscal year 2002/03 consistent with the revised fiscal framework presented in the letter of intent; (ii) international tendering of the financial audit of the CBE; and (iii) the revision of the recently adopted regulation for the provisioning by banks for nonperforming loans and other doubtful assets to bring it more in line with international best practice, by including five categories for the classification of nonperforming loans, and removing any temporary weakening of provisioning that may result from the phasing in of the new requirements.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 02/113
FOR IMMEDIATE RELEASE
October 3, 2002

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Concludes 2002 Article IV Consultation with Ethiopia

On September 23, 2002, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Ethiopia.[1]

Background

Overall economic performance in Ethiopia during 2000/01 (fiscal year ended July 7) and the first part of 2001/02 was good, in the context of Ethiopia's steady progress toward peace with Eritrea. The authorities have been implementing wide-ranging structural reforms and pursuing prudent macroeconomic policies. However, with per capita income still about US$100, Ethiopia remains one of the poorest countries in the world and continues to face major challenges.

Following a bumper crop, real GDP growth rose to 7.7 percent in 2000/01 but declined to 5 percent in 2001/02, as prices of coffee and cereals continued to fall and the growth of agricultural output returned to a more sustainable pace. Consumer price inflation remained negative in 2001/02. However, since July 2002, there has been a drought which is affecting food production. The authorities have been requesting additional food assistance from donors. The external current account deficit (including official transfers) widened to 6.6 percent of GDP in 2001/02 from 4.2 percent in 2000/01, on account of higher food imports. Coffee exports, which account for 40 percent of merchandise exports, were lower than expected, as both volume and prices fell.

[1] 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.

The fiscal deficit (including grants and special programs) increased in 2001/02, as a result of the accelerated implementation of special programs, capital expenditure, and poverty-targeted expenditure, the latter of which reached 16.7 percent of GDP. With regard to tax policy measures, the large taxpayer unit and tax reform implementation task force established in 2001 have been strengthened, and draft legislation for the introduction of a value-added tax (VAT) was passed by parliament in early July 2002. Defense outlays were cut from 6.4 percent of GDP in 2000/01 to 5.9 percent in 2001/02.

Broad money rose by 10.9 percent in 2001/02 compared with 9.5 percent in 2000/01. Several measures were taken to improve the soundness of the financial sector. The wholesale foreign exchange auction began to operate more efficiently before its replacement by an interbank foreign exchange market in October 2001.

Progress was also made in implementing other structural reforms focused on public sector management, including civil service and public expenditure policy, and on private sector development. Revised investment and urban land lease laws were adopted. However, implementation of the privatization program slowed because the larger companies, including industrial enterprises, that were being sold attracted fewer potential buyers.

The poverty reduction strategy paper was prepared with full participation by civil society and development partners, and was submitted to the Fund and the World Bank in August 2002.

Executive Board Assessment

Executive Directors noted that the authorities have made good progress in the implementation of sound macroeconomic policies and structural reforms. However, after the bumper crop in 2000/01, real economic growth is estimated to have decelerated from 7.9 percent in 2000/01 to 5 percent in 2001/02. Since July of 2002, Ethiopia has suffered from a drought, which is affecting food production and causing food shortages in some regions, as well as a rebound in cereal prices after a two-year decline. The authorities have subsequently requested additional food assistance from donors.

Directors observed that, as one of the poorest countries in the world, Ethiopia faces major challenges, particularly the achievement of sufficiently high rates of real GDP growth over the medium term to help reduce poverty. To this end, Directors encouraged the authorities to implement decisively structural reforms that enhance the efficiency of the economy and improve its competitiveness, and to continue with prudent macroeconomic policies, including a sustainable fiscal policy.

Directors noted that the largely agricultural-based economy is vulnerable to exogenous shocks, and shared the authorities' concern about the continued drop in producer prices of cereals and coffee. They encouraged the authorities to take action to mitigate the impact of these developments. From a long-term perspective, they considered that a key challenge for the authorities in the medium term will be to diversify the production base of the economy.

Directors underlined that a significant reduction of the fiscal deficit in the coming years is needed for macroeconomic stability and debt sustainability. They urged the authorities to persevere with their cautious expenditure policy, and stressed the need to pursue vigorously their efforts to improve the planning, tracking, and reporting of public spending, especially poverty-reducing spending. In this context, they shared the view that decentralization of public spending should be conditional on an improvement in the effectiveness, reporting, and monitoring of local government spending. Directors welcomed, however, the shift in spending from defense to the social and economic sectors since the Poverty Reduction and Growth Facility-supported program was adopted in late 2000, and encouraged further steps in this direction.

Directors were encouraged by the authorities' efforts to mobilize tax revenue by strengthening tax administration and reforming the tax systems, noting the rise in the ratio of collections to GDP in the last two years. However, they considered that there is room for further improvement in revenue collection, and urged the authorities to continue to implement the tax reforms in a timely manner. They welcomed the planned introduction of the value added tax and the tariff reform in January 2003, and urged the authorities to step up the preparations for these measures.

Directors endorsed a cautious monetary policy stance to maintain price stability, sharing the staff view that the authorities should keep interest rate policy under review. They considered appropriate the current exchange rate regime and policy stance. Directors welcomed the elimination of certain exchange restrictions, and encouraged the authorities to further liberalize the foreign exchange market and eliminate the remaining restrictions.

Directors urged the authorities to pursue vigorously their efforts to strengthen the financial sector and enhance its competitiveness, and to improve monetary management. They welcomed the ongoing efforts to address the difficulties of the largest state-owned bank. Many Directors recommended that the authorities reconsider the existing policy of not allowing entry of foreign banks, stressing that foreign banks would bring more diversified lending and enhance bank efficiency by increasing competition.

Directors stressed the importance of implementing other structural reforms that are conducive to economic growth and poverty reduction, including agricultural reform, capacity building, export promotion, the strengthening of the existing legal and regulatory framework, and civil service reform. They encouraged the authorities to accelerate the privatization program in order to spur private sector activity.

Directors welcomed the completion of the full Poverty Reduction Strategy Papers (PRSP), which should substantially help Ethiopia's fight against poverty. They commended the authorities for the wide and full participatory process with civil society and development partners. They observed, however, that more prioritization is needed and that there are downside risks to the implementation of the proposed policies and reforms, including the vulnerability of Ethiopia to exogenous shocks. Some Directors noted that the PRSP projections might be overly optimistic, particularly in light of the pressures currently facing Ethiopia.

Directors agreed that the medium term macroeconomic framework incorporated in the PRSP should be carefully evaluated once additional external assistance is identified.

Directors noted the progress being made in improving the macroeconomic statistics in line with Fund recommendations, and urged the authorities to intensify their efforts in this area. They welcomed Ethiopia's intention to participate in the General Data Dissemination System.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board.

Ethiopia: Selected Economic Indicators, 1997-2002 1/

	1997	1998	1999	2000	2001	2002
	(Annual percentage change)					
Domestic economy						
GDP at constant prices (at factor cost)	4.7	-1.4	6.0	5.4	7.7	5.0
GDP deflator	3.7	10.2	1.6	1.1	-8.2	-7.4
Consumer prices (period average)	-6.4	3.6	3.9	4.2	-7.2	-7.2
	(In percent of GDP)					
Gross domestic investment	17.0	17.2	16.3	15.3	18.0	20.2
Government investment	8.3	7.4	7.9	5.3	8.9	12.6
Private investment	8.7	9.8	8.4	9.9	9.2	7.5
Gross domestic saving	7.9	7.7	1.4	-0.1	2.2	1.5
Government saving	6.8	3.3	-0.6	-4.9	2.0	0.7
Private saving	1.2	4.4	2.0	4.8	0.2	0.8
National saving	14.0	15.6	8.3	10.0	13.7	13.5
	(In percent of GDP, unless otherwise indicated)					
Financial variables						
Government revenues and grants	21.8	20.8	21.4	21.6	24.6	27.0
Of which: tax revenue	12.9	11.7	11.5	12.5	14.3	16.2
Government expenditure and net lending, including special programs 2/	24.2	25.2	30.6	33.1	30.4	36.9
Overall fiscal balance, including grants and special programs 2/	-2.4	-4.3	-9.2	-11.5	-5.7	-9.9
Broad money (annual percentage change)	3.4	12.7	5.9	14.0	9.5	10.9
	(In millions of U.S. dollars, unless otherwise indicated)					
External economy						
Exports, f.o.b.	599	602	484	486	441	400
Of which: coffee	355	420	281	262	175	156
Imports, c.i.f.	1,310	1,357	1,558	1,611	1,556	1,629
Current account balance (including official transfers) (in percent of GDP)	-3.0	-1.6	-7.9	-5.3	-4.2	-7.1
Overall balance of payments	-720	-507	-473	-366	-71	232
Gross official reserves (in months of imports of goods and services)	4.2	2.6	2.7	2.2	2.0	3.9
Debt service (in percent of exports of goods and nonfactor services) 3/	84.1	57.7	63.3	52.2	23.2	22.4
External debt (in percent of GDP) 4/	79.8	78.8	82.4	85.7	90.1	102.3
Terms of trade (deterioration -) (annual percentage change)	10.5	18.1	-15.9	-33.9	-6.3	-6.6
Real effective exchange rate (end of period) (annual percentage change)	1.2	-1.1	0.9	-1.2	-12.3	...

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

1/ Fiscal year ended on July 7.
2/ Demobilization and reconstruction.
3/ Before debt relief; on an accrual basis.
4/ Before 1999/2000, post-debt relief; thereafter, pre-debt relief.

INTERNATIONAL MONETARY FUND

NEWS BRIEF

FOR IMMEDIATE RELEASE

News Brief No. 02/99
FOR IMMEDIATE RELEASE
September 24,2002

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Completes Review Under Ethiopia's PRGF Arrangement and Approves US$14 Million Disbursement

The Executive Board of the International Monetary Fund (IMF) has completed the third review of Ethiopia's performance under the three-year Poverty Reduction and Growth Facility (PRGF) arrangement. As a result, Ethiopia will be able to draw up to SDR 10.43 Million (about US$14 million) under the arrangement immediately.

Ethiopia's PRGF arrangement was approved on March 22, 2001 (see Press Release No. 01/11) for SDR 86.9 million (about US$115 million). On March 18 2002, the Board decided to increase the PRGF arrangement by SDR 13.38 million (about US$18 million) to help mitigate the impact on the balance of payments of a continued deterioration of the terms of trade and the events of September 11. So far, Ethiopia has drawn SDR 58.56 million (about US$77 million).

The PRGF is the IMF's most concessional facility for low income countries. It is intended that PRGF-supported programs will in time be based on country-owned poverty reduction strategies adopted in a participatory process involving civil society and development partners, and articulated in a Poverty Reduction Strategy Paper (PRSP). This is intended to ensure that PRGF-supported programs are consistent with a comprehensive framework for macroeconomic, structural, and social policies to foster growth and reduce poverty. PRGF loans carry an annual interest rate of 0.5 percent and are repayable over 10 years with a 5 ½-year grace period on principal payments.

Following the Board's discussion on Ethiopia, Shigemitsu Sugisaki, Deputy Managing Director and Acting Chair, stated:

"Ethiopia's performance during the first annual program under the PRGF arrangement was good, and the second annual program remains on track. Real GDP growth remained strong at an estimated 5 percent in 2001/02, while inflation remained negative as a result of food surpluses following the bumper crop in 2000/2001. However, since July of 2002, Ethiopia has suffered from a drought, which is affecting food production and causing food shortages in some regions, as well as a rebound in cereal prices. The authorities have subsequently requested additional food assistance from donors.

"All the quantitative and structural performance criteria and benchmarks under the PRGF arrangement for December 2001 and March 2002 were met, with the exception of that concerning the revision of the regulation governing banks' provisioning for nonperforming loans. This regulation was amended in August 2002 to bring it more in line with international best practice.

"The fiscal deficit (including grants and special programs) increased considerably in 2001/02, as a result of the accelerated implementation of special programs and capital and poverty-targeted expenditure. Several tax policy measures were implemented. Defense outlays were cut further. Broad money for the first nine months of 2001/02 increased by less than programmed. Several measures were taken to improve the soundness of the financial sector. The wholesale foreign exchange auction began to operate more efficiently and was replaced by an interbank foreign exchange market in October 2001. The exchange rate regime and policy remain adequate.

"The policies to be implemented in the remainder of the second annual program should sustain economic performance. Real GDP growth is currently projected to rise to 6 percent in 2002/03, but is likely to be affected by the recent developments. Average consumer price inflation is expected to rise to 4.5 percent. The external current account deficit is projected to increase somewhat in 2002/03, as official transfers decline to a more sustainable level.

In the fiscal area, the overall deficit (including grants and special programs) is to be limited to 9.7 percent of GDP in 2002/03. Progress with tax administration reform will continue, and the value added tax is to be introduced in January 2003. On the spending side, a cautious stance will be pursued, with defense spending maintained at the nominal level of the previous year, while poverty-targeted outlays will be increased. The planning, tracking, and reporting of public expenditure will be further strengthened.

"Reforms are to be implemented to strengthen the financial sector and improve its competitiveness. A financial audit of the Commercial Bank of Ethiopia is to be undertaken, with a view to preparing a restructuring plan. Other structural reforms are to be pursued in 2002/03 to foster agriculture growth and private sector development, improve public expenditure management and control, and build institutional capacity in the public service," Mr. Sugisaki said.