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Ethiopia: Second Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility, Requests for Augmentation of Access and for Waiver of Performance Criterion, and Second Annual Program—Staff Report and News Brief on the Executive Board Discussion

In the context of the Second Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility, Requests for Augmentation of Access and for Waiver of Performance Criterion, and Second Annual Program, the following documents have been released and are included in this package:

- the staff report for the Second Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility, Requests for Augmentation of Access and for Waiver of Performance Criterion, and Second Annual Program, prepared by a staff team of the IMF, following discussions that ended on **February 27, 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 March 1, 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 News Brief summarizing the **views of the Executive Board as expressed during its March 18, 2002 discussion** of the staff report that completed the review.

The documents listed below have been or will be separately released.

Letter of Intent sent to the IMF by the authorities of Ethiopia*
Memorandum of Economic and Financial Policies by the authorities of Ethiopia*
Technical Memorandum of Understandings*

*May also be included in Staff Report.

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

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ETHIOPIA

Second Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility, Requests for Augmentation of Access and for Waiver of Performance Criterion, and Second Annual Program

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 G.E. Gondwe and Mark Allen

March 1, 2002

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EXECUTIVE SUMMARY

Recent developments and performance under the first annual program

- **Performance under the first annual PRGF-supported program was satisfactory** in the context of Ethiopia's steady progress toward peace with Eritrea. Real GDP growth for 2000/01 is estimated at 7.9 percent, while inflation turned negative, reflecting a bumper cereal crop and large inflows of food aid. The external current account deficit (including official transfers) fell to 4.2 percent of GDP from 5.2 percent in 1999/2000. All quantitative and structural performance criteria through October 2001 were observed, with the exception of the adjusted performance criterion on the net domestic assets of the National Bank of Ethiopia (NBE), for which the authorities request a waiver.

- **The fiscal deficit (including grants and emergency programs) narrowed** to 5.6 percent of GDP in 2000/01, much lower than the program target, as a small shortfall in revenues was more than offset by lower spending. Several tax policy measures were implemented. Defense outlays were cut, and poverty-targeted outlays increased. **In the monetary and exchange areas,** the authorities sterilized some excess liquidity and took steps to adopt indirect monetary instruments; they also moved toward market determination of interest and exchange rates. However, the market is still dominated by the Commercial Bank of Ethiopia (CBE). The wholesale foreign exchange auction was replaced by an interbank foreign exchange market in October 2001.

Ethiopia: Selected Economic and Financial Indicators, 1999/2000-2003/04 1/

	1999/2000	2000/01		2001/02	2002/03	2003/04
		Program	Estimate	Rev. Prog.	Projections	
	(Percentage change)					
Real GDP	5.4	7.8	7.9	5.8	6.0	6.0
Inflation	4.2	5.2	-7.2	3.0	3.0	3.0
Money supply (M3)	14.0	12.5	9.5	11.1	9.9	9.1
	(In percent of GDP)					
Fiscal balance (incl. grants, excl. special programs)	-11.4	-6.4	-4.8	-6.9	-5.9	-4.1
Special (post-conflict) programs	0.0	1.9	0.8	2.2	1.9	0.8
External current account balance (incl. official transfers)	-5.2	-5.7	-4.2	-7.1	-6.2	-4.6
	(In months of imports)					
Gross official reserves	2.2	2.6	2.0	2.9	3.8	4.0

Sources: Ethiopian authorities; and staff estimates and projections.
1/ Year ending July 7.

Policies for the second annual program

- Under the macroeconomic framework, updated to take into account recent developments, continued terms of trade deterioration, and the adverse impact of the September 11, 2001 events, real GDP growth is projected at 5.8 percent in 2001/02 and 6 percent in 2002/03. Average consumer price inflation is expected to rise to 3 percent in both 2001/02 and 2002/03. The external current account deficit is projected to widen to 7.1 percent of GDP in 2001/02 before narrowing to 6.2 percent in 2002/03. To mitigate the adverse impact of recent events, the government requests an increase in access of 10 percent of quota (SDR 13.37 million) under the PRGF arrangement, to be disbursed at the completion of the second review.

- In **the fiscal area,** the overall deficit (including grants and special program expenditure equivalent to 2.9 percent of GDP) is to be limited to 9.1 percent of GDP in 2001/02, and 7.8 percent in 2002/03. The authorities are pursuing their tax reform program with the recent establishment of a large-taxpayer unit and the preparation for the introduction of the value-added tax in January 2003. On the spending side, a cautious stance will be pursued, with further cuts in defense spending, while poverty-targeted outlays will be increased. A comprehensive plan to enhance budget formulation, execution, and reporting is being implemented.

- In the **monetary and exchange areas,** further reforms will be implemented to strengthen the financial sector and improve its competitiveness, including the submission to the NBE board of an audit of the NBE's financial statements for the year ended June 30, 2001; the adoption of regulations for the provisioning of nonperforming loans and other doubtful assets; and the signing of a performance contract between the government and CBE. A workshop will be held with Fund and Bank staffs to discuss the competitiveness and role of foreign banks in the financial sector.

- On **other structural reforms**, the authorities are pursuing public service capacity building and privatization programs and, with the support of the World Bank, implementing reforms in the areas of agriculture, export promotion, the civil service, and public expenditure management and control.

Issues stressed in the staff appraisal

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

- It is important to persevere with efforts for further fiscal consolidation, the reorientation of budgetary resources from defense toward poverty alleviation outlays, and tax reforms that lay the foundation for a strong revenue performance.

- Far-reaching reforms to strengthen the financial sector and improve its competitiveness should be implemented. In particular, the authorities should push ahead with a genuine reform of the CBE, particularly to reduce its dominance, strengthen bank supervision, ensure greater autonomy of the NBE, and rehabilitate weak banks. To ensure the competitiveness of the financial sector, the authorities should also allow foreign bank entry (or, as a minimum, foreign minority shareholding).

- The agenda of structural reforms should be adhered to, in particular the privatization program. In addition, the preparation of a high-quality full PRSP should continue, with complete participation by civil society and development partners.

I. Introduction

1. Discussions on the second review and the second annual program under the three-year Poverty Reduction and Growth Facility (PRGF) arrangement were held in Addis Ababa during November 8-22, 2001.[1] The attached letter from the Minister of Finance and Economic Development of Ethiopia and the Governor of the National Bank of Ethiopia (NBE), and the annexed memorandum on economic and financial policies (MEFP), dated December 31, 2001 (Appendix I),[2] review progress made under the first annual program (October 2000-September 2001) and recent economic developments, and set out the policies and measures to be implemented by the government during the second annual program (October 2001-September 2002). 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, the government requests an increase in access of 10 percent of quota (SDR 13.37 million) under the arrangement, to be disbursed in its entirety at the completion of the second review.

2. The PRGF arrangement for Ethiopia, 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/01/13, 2/5/01).[3,4]

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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, 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; the Speaker of the Parliament, Mr. Dawit Yohannes, and other parliamentarians; and representatives of the private sector, bankers, nongovernmental organizations, and donors. The mission team consisted of Mr. Tahari (head), Mr. Guillaume, Ms. Strauss, and Mr. Bhavnani (Research Assistant) (all AFR), Mr. Gilmour (PDR), and Mrs. Vibar (Administrative Assistant-AFR). Mr. Kyei, the Fund's Resident Representative, assisted the mission. Ms. Rendak (LEG) joined the mission to assess compliance of Ethiopia's legislation with Article VIII of the Fund's Articles of Agreement.

[2] The paragraphs in the MEFP relating to the Commercial Bank of Ethiopia (CBE) were revised on February 27, 2002, to take into account the withdrawal in early January of a foreign bank from a management contract signed in June 2001, which did not permit its entering into effect as a prior action. In the event, understandings were reached in February with the authorities on measures to address the immediate financial difficulties and management issues of CBE, which are reflected in paragraphs 11 and 24 of the MEFP (Appendix I).

[3] Concurrently with Board approval of the PRGF arrangement, the Boards of the Fund and IDA considered Ethiopia's interim poverty reduction strategy paper (PRSP) (EBD/01/10, 1/30/01) and the joint staff assessment (EBD/01/11, 1/30/01). They also reconfirmed Ethiopia's eligibility under the enhanced HIPC Initiative.

The second disbursement (SDR 17.38 million) was effected following the completion of the first review by the Executive Board on August 1, 2001 (EBS/01/108, 7/5/01); and availability of the third disbursement, including the requested increase in access of 10 percent of quota (totaling SDR 23.80 million), would be contingent on the completion of the second review, including observance of end-September 2001 quantitative performance criteria (Table 2). At the time of the completion of the first review, the Executive Directors considered that Ethiopia had performed well under its PRGF-supported program. They stressed the importance of further fiscal consolidation, including the continued reorientation of budgetary resources from defense toward poverty alleviation, and they called for far-reaching reforms to strengthen the financial sector and improve its competitiveness.

3. The Executive Boards of the Fund and the World Bank decided on November 6 and 8, 2001, respectively, that Ethiopia was eligible for 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) to help the recovery of the country's post-conflict economy was approved in June 2001.

II. Performance Under the First Annual Program and Recent Economic Developments

4. **With Ethiopia's emergence from the conflict with Eritrea in 2000,[5] the government resumed its economic reform efforts and reconfirmed its commitment to poverty reduction within a framework of macroeconomic stability, as laid out in its interim PRSP**. The PRGF-supported program for 2000/01-2002/03 (fiscal year ending July 7) sought to (a) increase annual economic growth from 5½ percent in 1999/2000 to around 7 percent; (b) limit inflation to low single digits; and (c) raise the import reserve cover to about four months.[6]

[4] Ethiopia's outstanding use of Fund resources amounted to SDR 86.15 million (64.4 percent of quota) on October 31, 2001. 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 (Table 1).

[5] In the second half of 2000, considerable progress was made toward restoring peaceful conditions between Ethiopia and Eritrea. On December 12, 2000, the two countries signed a peace agreement, and to-date, Ethiopia has demobilized 100,000 soldiers or 28 percent of the armed forces.

[6] For more details, see EBS/01/6 (1/30/01), EBS/01/13 (2/5/01), and EBS/01/108 (7/5/01).

5. **Performance under the first annual program was satisfactory.** Real GDP growth in 2000/01 is estimated to have been about 7.9 percent, inflation turned negative, reflecting a bumper cereal crop and large inflows of food aid,[7] and the external current account deficit (including official transfers) narrowed to 4.2 percent of GDP from 5.2 percent in 1999/2000 (Table 3 and Figure 1). Coffee exports (which accounted for 40 percent of merchandise exports in 2000/0l) were lower than expected, as both volume and prices fell (Box 1). This trend continued during the first quarter of 2001/02. With a slower-than-anticipated pace of project implementation, imports were also lower than expected.

6. Most quantitative performance criteria and benchmarks through end-October 2001 were observed (Appendix I, Table 1). Quantitative benchmarks for July 7, 2001 were met, with the exception of the floor on the net foreign assets, and the ceiling on the net domestic assets of the NBE. The program benchmarks were calculated on the assumption that a US$150 million balance of payments IDA credit would be disbursed before end-June 2001. In the event, the IDA credit was disbursed a few days later, on July 9, 2001, and calculations indicate that the net foreign assets floor and the net domestic assets ceiling would have been observed with large margins if these funds had been disbursed as originally anticipated. The quantitative performance criteria and benchmarks for end-September 2001 were met, with the exception of the adjusted performance criterion on the net domestic assets of the NBE, for whose non-observance the authorities are requesting a waiver.[8] Structural performance criteria and benchmarks through end-October 2001 were also observed (Appendix I, Table 3), with the exception of the introduction of the interbank foreign exchange market on October 1 (benchmark); this action was postponed by a few weeks because the provision of technical assistance by the Fund was delayed as a result of the travel suspension related to the events of September 11, 2001.

7. **The fiscal deficit (including grants and emergency programs) narrowed from 11.4 percent of GDP in 1999/2000 to 5.6 percent in 2000/01, much lower than the program target of 8.4 percent of GDP**. A small shortfall in revenue was more than offset by lower spending (Tables 4 and 5). Several tax measures were implemented, a large-taxpayer unit was made operational in July 2001, and a draft value-added tax (VAT)

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[7] The bumper crop and food aid led to very low farm-gate prices.

[8] While overall domestic borrowing was lower than programmed, net credit to the government from the NBE exceeded the adjusted program ceiling, as the electric power company did not roll over treasury bills amounting to about Br 600 million. The funds were held with a commercial bank, which subsequently increased its holdings of treasury bills, and by October 2001, the net domestic assets of the NBE returned to its programmed path. The authorities also noted that the delays in the disbursement of the IDA credit led to a significant adjustment of the ceiling for end-September 2001 (Appendix I, Table 1).

Box 1. Ethiopia: Coffee Sector–Recent Developments and Outlook

The Ethiopian coffee sector directly and indirectly employs over 25 percent of the country's population. Coffee exports, the country's largest foreign currency earner, accounted for 43 percent of coffee production and 40 percent of merchandise exports in 2000/01 (July 8-July 7). Coffee is a perennial crop, 95 percent of which in Ethiopia is cultivated by smallholders in plots averaging 0.4 hectares.

Recent developments and outlook

In the three years preceding end-2000/01, coffee export prices and volumes declined by 37 percent and 20 percent respectively. This trend continued in the first three months of 2001/02, as coffee export prices fell by 3 percent against the 2000/01 average export price, and export volumes decreased by 35 percent, compared with the same period in 2000/01. As per the latest *World Economic Outlook*, international coffee prices are projected to decline by nearly 15 percent in 2001/02, before recovering through 2002/03-2005/06. However, this recovery will start from a low base, and prices are expected to remain historically low in 2005/06. As stocks held from last year need to be sold before their quality deteriorates and the authorities encourage exports (see below), export volumes are expected to recover in the second half of 2001/02, leading to an overall coffee export volume growth of 4 percent. Export earnings are projected to decrease by 11 percent, compared with 2000/01. In the medium term, volumes should recover in line with prices, growing by an average of 6 percent a year.

Policy response

Concerned by the developments, the authorities have (a) announced that the 6 percent coffee export tax will not be collected if export prices fall below 70 cents per lb. for unwashed coffee and 105 cents per lb. for washed coffee (coffee prices have remained below this floor since August 2000, and export taxes have not been collected since May 2001); (b) suspended the 5 percent withholding income tax on proceeds from coffee exports; and (c) eased restrictions on the domestic sale of export-quality coffee and the transfer of coffee between regions. Additionally, to prevent cash shortfalls, banks extending credit to middlemen (called wholesalers) have been refinancing their loans as needed. This benefits small producers as well, since wholesalers often finance producer activities. Also, the Coffee and Tea Authority has been encouraging exporters to meet market demand at lower prices. Ongoing efforts to boost coffee exports and increase domestic value added in the medium term include (a) increasing exports of washed coffee, which commands a premium (washed coffee constituted 24 percent of coffee exports in 2000/01, up from 17 percent in 1996/97); (b) preparing for the certification of organically grown Ethiopian coffee; and (c) reducing state participation in the sector (parastatals exported 5 percent of coffee volume in 2000/01, down from 32 percent in 1996/97). The authorities are considering moving from the present auction system to a commodity exchange for coffee exports. They are also trying to mitigate the social impact of the recent downturn in prices (see Box 2).

Ethiopia: Coffee Sector Production, Prices and Exports, 1997/98-2003/04 1/

	1997/98	1998/99	1999/2000	2000/01	2001/02	2002/03	2003/04
	(In metric tons; unless otherwise specified)						
Production	230,000	232,000	230,000	221,000	230,000	241,500	253,575
(percent change)	0.9	0.9	-0.9	-3.9	4.1	5.0	5.0
Exports	120,006	101,231	116,557	96,000	100,000	110,000	115,600
(percent change)	-2.6	-15.6	15.1	-17.6	4.2	10.0	5.1
Export earnings (millions of U.S. dollars)	420	281	262	175	155	178	203
(percent change)	18.3	-33.1	-6.8	-33.2	-11.4	14.8	14.0
	(In birr per metric ton)						
Producer price	13,312	11,441	11,510	9,406	8,099	...	...
(percent change)	34.3	-14.1	0.6	-18.3	-13.9	...	...
Export price	24,013	20,891	18,324	15,198	13,334	14,171	15,562
(percent change)	28.3	-13.0	-12.3	-17.1	-12.3	6.3	9.8

Sources: Coffee and Tea Authority; National Bank of Ethiopia; and Fund staff estimates.

1/ Data for 2001/02-2003/04 are projected. The producer price for 2001/02 is for the first quarter of the fiscal year.

legislation was submitted to parliament on October 1, 2001 (both performance criteria).[9] The authorities followed a cautious expenditure management policy because of uncertainty regarding the disbursement of program aid.[10] Defense expenditures amounted to 6.2 percent of GDP (lower than the programmed 7.3 percent of GDP in 2000/01), and poverty-targeted outlays (health, education, agriculture, and roads) reached 10.9 percent of GDP (Box 2). Capital spending and the implementation of emergency programs (demobilization and reconstruction) were slower than expected, largely because of delays in the disbursement of external assistance.

8. **In the monetary and exchange areas, the authorities sterilized some excess liquidity and began taking steps to adopt indirect monetary management instruments and move towards market determination of interest and exchange rates. However, the market is still dominated by the Commercial Bank of Ethiopia (CBE).** Reflecting lower-than-projected nonagricultural economic activity and inflation, broad money growth slowed to 9.5 percent in 2000/01 (compared with 12.5 percent under the program), from 14 percent in 1999/2000, and credit to the economy increased by 7.6 percent (compared with 18.4 percent in the program), down from 10.1 percent in 1999/2000 (Table 6). Net central bank credit to the government declined, more rapidly than envisaged under the program, by 30 percent, as the government relied more on borrowing from commercial banks. Increased sales of government securities reduced banks' excess reserves from 29.6 percent of deposits in September 2000 to 5.3 percent in July 2001; however, the ratio rose again to 9.7 percent in September 2001 before falling to 5.2 percent by end-October.[11] Several measures were taken to strengthen the CBE and improve the competitiveness of the financial sector, including the issuance of government guarantees for assets held in Eritrea, the reconstitution of the CBE's board to increase private sector participation, and the lifting of restrictions on the payment of interest on current account deposits. However, delays occurred in the restructuring of the Development Bank of Ethiopia and the bringing to the point of sale of the Construction and Business Bank of Ethiopia. A management contract between CBE and a foreign bank was

[9] Some delays, however, occurred in the overhaul of the tax administration.

[10] Some donors had postponed aid disbursement until the establishment of the 25-kilometer Temporary Security Zone between Ethiopia and Eritrea in April 2001.

[11] The government auctioned two-year bonds in November 2000, which served to mobilize most of the excess reserves in the banking system. Regular biweekly treasury bill auctions are conducted to raise government funding or manage liquidity at the margin. The increase in excess reserves in September 2001 emanated largely from the decision by the electric power company not to roll over its holdings of treasury bills. The funds were held with a commercial bank, which subsequently increased its holdings of treasury bills, thereby reducing the level of excess reserves to 5.2 percent by end-October 2001.

Box 2. Ethiopia: Poverty Reduction and Social Impact under the PRGF-Supported Program

With an annual per capita GDP of US$100 in 2000/01, and a rank of 158 (out of 162 countries) on the United Nations Development Program 2001 human development index, Ethiopia is one of the poorest countries in the world. This extreme poverty is exacerbated by a high level of vulnerability and the large variance in levels of essential food consumption. Living standards are significantly lower in Ethiopia than the sub-Saharan African average, with life expectancy at about 42 years, and 46 percent of the 15-24 age group illiterate. The rural-urban welfare gap, regional disparities, and gender inequalities are also marked.

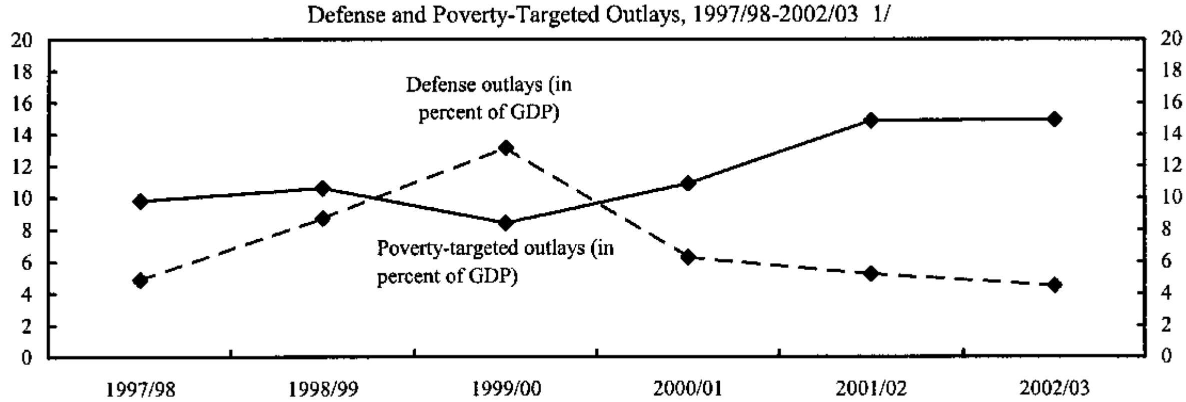
The authorities have put the reduction of poverty at the center of their medium-term growth strategy, as outlined in their interim PRSP. More specifically, the medium-term economic program, supported by a three-year PRGF arrangement, directly focuses on the poor and vulnerable by (a) redirecting defense expenditure to poverty-targeted outlays in health, education, agriculture, and road construction; (b) restoring crucial physical infrastructure, and reconstituting and improving the income-earning capacity of dislocated and deported households and veterans with the support of emergency programs; (c) implementing a food aid strategy, and (d) executing a multi-sectoral HIV/AIDS strategy.

The sharp increases in defense expenditures during the two year conflict period 1998-2000, were followed by significant decrease in the aftermath of the conflict. These trends in defense-related expenditures have allowed sizeable increases in poverty-related expenditures, as illustrated in the figure below. The recent emphasis on the social sectors is also apparent in real per capita expenditures. In the education sector, real per capita expenditure declined from Br 8.7 in 1998/99 to Br 8.2 in 1999/2000 before increasing to an estimated Br 10.7 in 2000/01. Trends in health sector real per capita expenditures are even more pronounced with a decline from Br 3.5 in 1998/99 to Br 2.7 in 1999/2000, and an increase to Br 4.0 in 2000/01. Given Ethiopia's low expenditure levels in these sectors, reversing past trends is particularly critical for the realization of the poverty reduction objectives of the government.

The authorities sought to mitigate the impact of the sharp decline in coffee prices—a decrease of more than 29 percent in coffee producer prices between July 1998 and June 2001—by suspending the export tax in May 2001. However, producer prices continued to fall—by 12 percent in the first quarter of 2001/02, while export margins have increased by 19 percent. Thus, the main beneficiary of the government's policy response (specifically on the suspension of the coffee export tax) has been exporters, and not producers. As a consequence, the authorities intend to take further steps to boost producer prices and exports.

In the context of the full PRSP, the authorities intend to conduct a detailed social impact analysis of key policies with donors' assistance. They will also develop a detailed strategy to fight the HIV/AIDS pandemic.

Defense and Poverty-Targeted Outlays, 1997/98-2002/03 1/



Sources: Ethiopian authorities; and Fund staff estimates.
1/ Poverty-targeted and total expenditures include the use of HIPC Initiative resources, and exclude special programs.

signed on June 29, 2001, and was expected to enter into effect after the Boards of the two institutions had resolved the only remaining issues relating to potential liability of the management and arbitration.[12] In the absence of an agreement on these issues, the foreign bank withdrew from the contract in early January 2002.

9. **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. **The wholesale foreign exchange auction was replaced by an interbank foreign exchange market in October 2001.** The value of the birr against the dollar fell by about 2.9 percent in 2000/01 and by another 0.7 percent in the first quarter of 2001/02 (Figure 2). At end-September 2001, net foreign assets of the NBE were estimated at US$281 million (about one month of import cover), compared with the programmed target of US$313 million.[13] Gross foreign reserves were estimated at about two months of import cover, of which half was gross liquid reserves.

10. In other **structural areas**, progress was made, with World Bank assistance, in implementing reforms focused on public sector management, including civil service reform and public expenditure policy, and on private sector development. The government also pursued its privatization program with the sale of seven public entities in 2000/01.

11. **On the political front**, the congress of the ruling coalition was held on September 14-16, 2001, and a new cabinet was formed in early October. This has eased the tense domestic political situation.

III. Medium-Term Economic Strategy

12. The second annual PRGF-supported program has been designed in the context of an updated medium-term framework (for 2001/02-2003/04), building on the progress made under the first annual program, and taking into account recent developments in the world economic environment and the impact of the September 11, 2001 events. The key objectives of the government's medium-term economic reform strategy, as outlined in the interim PRSP and the January 29, 2001 policy memorandum, are to promote rapid, broad-based, and equitable growth by emphasizing rural development and improvement in physical and human capital, and to address post-conflict reconstruction and reintegration needs.[14] The key

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[12] The foreign bank proposed an amendment to the contract to limit the new management's potential liability for any acts of financial malfeasance and to use a neutral law and country to arbitrate any dispute. The Board of CBE insisted that these issues be resolved in Ethiopia's court and that management's liability not be limited.

[13] If the delayed disbursement of the IDA credit of US$150 million on July 9 is taken into account, net foreign assets would have exceeded the target level.

[14] For more details, see EBS/01/6 (1/30/01); EBS/01/13 (2/5/01); and EBD/01/10 (1/30/01).

elements of the medium-term strategy continue to be (a) the reorientation of budgetary resources from defense toward poverty alleviation outlays; (b) tax (including external tariff) 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 growth prospects depend on success in increasing investment, rebuilding the country's infrastructure, improving the domestic budgetary revenue effort, strengthening expenditure management, and implementing efficiency-enhancing structural reforms.

13. Within this framework, the revised medium-term objectives for the next three years are (a) to achieve an annual real GDP growth of about 6 percent, lower than the 6.5-7 percent projected in the original program; (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, after a rise to 7.1 percent in 2001/02.

IV. The Second Annual Program (October 2001-September 2002)

A. Macroeconomic Objectives and Policies

14. The macroeconomic framework for 2001/02 and 2002/03 was updated in light of recent developments, the latest World Economic Outlook (WEO) price projections, and the impact of the events of September 11, 2001. Export prices of coffee, Ethiopia's main export, are projected to fall further by 15 percent in 2001/02, before increasing moderately in 2002/03 and over the medium-term. The slowdown of the world economy is also likely to result in smaller worker remittances and private capital inflows, as well as lower demand for Ethiopian exports. The activities of Ethiopian Airlines have also been affected. In the face of these difficulties, the government is determined to pursue a restrained fiscal stance and a cautious monetary policy; nonetheless, the macroeconomic objectives presented in the letter of intent of May 29, 2001 had to be revised. The adverse impact of recent events on Ethiopia's balance of payments, after taking into account lower levels of imports, is estimated at US$44 million in 2001/02 and US$41 million in 2002/03. This would be partly covered by lower reserve targets. The remainder could be covered by the requested augmentation of PRGF access (about US$17 million, or 10 percent of quota), and by additional assistance from the World Bank (US$20 million).[15] Since the adverse impact is already felt in the first quarter of 2001/02, the government requests the full disbursement of the increase in access at the time of the completion of the second review.

15. Although the authorities still expect real GDP growth of 6.5-7 percent in 2001/02, the program assumes that the rate would fall to 5.8 percent that year and remain close to 6 percent in 2002/03. These growth rates will still hinge on increasing government

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[15] The disbursement of the World Bank assistance is expected to be made at the time of the disbursement of the next balance of payments support credit in early 2002/03.

investment from 8.7 percent of GDP in 2000/01 to about 11 percent in 2001/02 and 2002/03, and on creating an environment that is conducive to a small increase of private investment to 8.7 percent of GDP by 2002/03.[16] After the bumper crop in 2000/01, growth of agricultural output should return to a sustainable level. Consumer price inflation is projected to rise to an average of 3 percent in 2001/02 and 2002/03, as food supply conditions return to a more normal level. The external current account deficit (including official transfers) is projected to widen to 7.1 percent of GDP in 2001/02, reflecting the above-mentioned global outlook, before falling to 6.2 percent in 2002/03 (Table 7). The import reserves cover is to increase from 2 months of next year's imports at end-June 2001 to 2.9 months at end-June 2002, and to 3.8 months at end-June 2003.

Fiscal policy

16. **Fiscal projections were updated, taking into account the approved budget for 2001/02, and with a view to limiting the deficit (including grants and special program expenditure equivalent to 2.9 percent of GDP) to 9.1 percent of GDP in 2001/02 and 7.8 percent in 2002/03.** The fiscal deficit is expected to widen by 3.5 percentage points of GDP in 2001/02 as a result of the accelerated implementation of special programs and capital expenditure, as well as additional poverty-targeted and capital expenditure—fully financed by concessional external assistance and enhanced HIPC Initiative interim assistance that were not included in the budget adopted in July 2001.[17] Based on the already confirmed external assistance (secured entirely on concessional terms), it will be possible to finance the fiscal deficit, as well as a net reduction in the government's debt to the banking system.

17. To achieve the tax revenue target of 14.7 percent of GDP in 2001/02, revenue performance will benefit from the full-year impact of the measures that have been implemented since early 2001 and from improved tax administration, especially the recent establishment of the large-taxpayer unit.[18] Efforts to collect tax arrears and combat fiscal fraud are to be enhanced. The pace of implementation of the tax reform program is to be accelerated, in particular the functioning of the large-taxpayer unit, the activity of the tax

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[16] Major capacity building and infrastructure expansion, the privatization of a large number of public enterprises, and further progress in financial sector reform should create an environment conducive to private investment.

[17] To reflect these developments, a supplementary budget was adopted by the government and submitted to parliament at end-November 2001.

[18] The large-taxpayer unit was established in July 2001 and will be strengthened with recruitment of additional staff for its revenue collection, accounting and audit functions, the development of new procedures, and training of staff. In the recent cabinet reshuffle, the revenue department was moved from the Ministry of Finance and Economic Development to a new Ministry of Revenues.

reform task force, the implementation of the tax identification number pilot project, and the preparation for the introduction of the VAT in January 2003. A revised income tax law, with an improved penalty regime, will also be adopted in 2002.

18. On the expenditure side, total outlays are targeted to increase (excluding special programs) by 2 percent of GDP to 31 percent in 2001/02, but these will be reduced to 29.5 percent in 2002/03. Defense outlays are to be cut by 1 percentage point of GDP to 5.2 percent in 2001/02. Poverty-targeted spending is to be increased by 4 percent of GDP to 14.9 percent in 2001/02 (including 0.6 percent from debt relief under the HIPC Initiative). Capital outlays are to increase by 29 percent as project implementation and external disbursements are accelerated and more concessional resources are made available, especially from the World Bank and the African Development Bank.[19] The total wage bill will be limited to Br 4.2 billion (7.4 percent of GDP) in 2001/02. At the time of the first review, the authorities indicated their intention to assess at the time of the second review whether a modest general wage increase would be feasible and financeable within the budgeted envelope. With a lower-than-budgeted military wage bill and a slower filling of vacancies, it will be possible to provide a modest wage increase in January 2002, limited to Br 280 million on an annual basis and representing an average wage increase of 7 percent; the impact over the last six months in 2001/02 will not exceed Br 140 million. No further increases will be provided until a comprehensive civil service reform strategy has been adopted and a review of wage policy carried out in the context of this reform.

19. Regarding expenditure monitoring, the government's administrative capacity for simultaneously executing the sector development programs and the demobilization and post-conflict reconstruction programs is being enhanced. A benchmark for September 2002 was set for.the consolidation of federal and regional budgets—including all extrabudgetary funds and accounts—for both the past year and the budget year. The reporting and monitoring of local governments' expenditures will be enhanced. Also, a comprehensive short- and medium-term action plan to enhance budget formulation, execution, and reporting at the federal and regional levels is being implemented by the authorities in the context of its Expenditure Management and Control Program (Box 3).

Monetary and financial sector issues

20. The monetary program for 2001/02 and 2002/03 was updated with a view to achieving the inflation and international reserve targets under the program. The planned reduction in net claims to the government will help to achieve these targets while providing room for an adequate increase in credit to the nongovernment sector. Broad money supply is

[19] Most of the resources are to be used in the health, education, and agriculture sectors. These resources were included in the debt sustainability analysis presented in EBS/01/174 (10/16/01).

Box 3. Ethiopia: Public Expenditure Management

Despite a history of fiscal restraint and overall outturns close to original budgets, the current public expenditure management system in Ethiopia is relatively weak, mainly as a result of the important degree of decentralization to the regions; insufficient capacity, particularly at the regional levels; and lack of computerization.

Although regions collect only 15-20 percent of general government revenues, they account for nearly 35-40 percent of the total expenditure and as much as 70 percent of social expenditure. Regions are heavily dependent on federal subsidies, and are not permitted to borrow from external sources. They enjoy considerable autonomy in expenditure allocations. Some regions are even experimenting with further decentralization through a system of devolving block grants to zones and *woredas*—or districts—rather than passing on earmarked grants as per the budget.

Key challenges to improving public expenditure management in the immediate period ahead include (a) the formulation of budgets that integrate extrabudgetary expenditures and revenues such as food aid; (b) the further decentralization of expenditures to the *woreda* 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 budgetary 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 in poverty-related spending.

To meet these challenges and improve the public expenditure management system, the authorities have started implementing an ambitious set of reforms in the context of the Expenditure Management and Control Program, with the support of external technical assistance.

Key short-term reforms include the following: (a) *budget formulation*—the consolidation of federal and regional budgets (ex ante), starting FY 2002/03, at the beginning of the year, including all extrabudgetary funds and accounts; and the introduction of a two-year public expenditure program at the federal level; (b) *budget execution*—the introduction of cost center budgeting, modified cash (commitment) accounting, double-entry bookkeeping at the federal level; and the reconciliation of monetary and fiscal accounts, starting with FY 2001/02; and (c) *budget reporting*—the consolidation of federal and regional budget outturns (ex post), starting FY 2001/02, at the beginning of the year; the start of an integrated financial information system (IFMIS) pilot project for five federal agencies; and the review, and reform if necessary, of the institutional and legal framework for control, and 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 the internal audit, and the adoption of a 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.

projected to rise by about 11 percent in 2001/02 and 10 percent in 2002/03, broadly in line with the growth of nominal GDP (Table 6). The banks' excess liquidity should be curbed further through sales of government securities, to allow market-based monetary instruments to become more effective. The newly established interbank foreign exchange market is expected to allocate foreign exchange more efficiently.

21. Drawing on the recommendations of the Fund-World Bank technical assistance and the authorities' updated medium-term financial sector reform strategy, **the authorities will implement further reforms to strengthen the financial sector and improve its competitiveness.** The measures include (a) adopting regulations for the provisioning of nonperforming loans and other doubtful assets in line with international best practices[20] (set as a benchmark for March 2002 and also a completion point trigger under the enhanced HIPC Initiative); (b) allowing a bankers' association to be formally established; (c) taking 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; (d) ensuring that the Construction and Business Bank of Ethiopia is brought to the point of sale after its balance sheet has been restructured, based on the NBE's recommendations; (e) starting to implement a restructuring plan to address the weak financial condition of the Development Bank of Ethiopia; (f) encouraging public entities to do business with all banks by issuing a letter to these entities indicating that they are free to do business with banks of their choice; and (g) allowing private banks to enter into management contracts with foreign institutions (a HIPC Initiative completion point trigger). A workshop is to be held with Fund and Bank staffs to discuss the competitiveness of the financial sector and the role of entry of foreign banks in the sector.

22. **With respect to the CBE,** which still dominates the financial market with over 80 percent of bank deposits and about 60 percent of bank loans, as noted earlier the management contract for 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 has alleged the presence of corrupt practices at CBE and arrested 28 past CBE officials, 13 current managers (including the President and Vice President of CBE), and 12 private sector borrowers. These charges are under investigation. The CBE's financial situation also deteriorated in 2001, with nonperforming loans increasing from about 29 percent of total loans at end-2000 to 39 percent at end-2001. Against this background the authorities are implementing the following measures (see paragraph 24 of MEFP). First, the authorities have appointed a credible new management that will operate CBE on a commercial basis. Second, a performance contract will be signed between the government and the new CBE management by June 30, 2002 to ensure that CBE is operated effectively on commercial basis so as to achieve the necessary improvements in financial performance as recommended by the comprehensive audit carried out by Ernst and Young in 2000. Third,

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[20] Taking into account the Basel Committee guidelines on banking supervision for the restructuring of troubled debt and credit risk.

to assist the new management, CBE will be concluding a twinning arrangement with—or hire consultants from—reputable foreign institutions by end-September 2002. In the meantime, to improve its financial situation, CBE will fully implement the new provisioning directive to be adopted by end-March 2002. The reserve requirement will be strictly enforced and there will be no lending from the Central Bank to CBE. Also, lending authority will be transferred from the Board of CBE to management, with the Board focusing on oversight. Finally, also as a benchmark under the PRGF program, nonperforming loans are to be reduced by Birr 0.8 billion (8 percent of total loans), including through write-offs, by end-September 2002. As had been contemplated under the management contract with a foreign bank, the performance contract between CBE and the government will ensure that the new management has decision-making autonomy, including on lending, staffing, meeting performance targets, pursuing delinquent borrowers, as well as taking steps to strengthen the CBE's cost competitiveness and profitability. These measures are consistent with the findings and recommendations of the Ernst and Young study. The staff urged the authorities to take every possible measures to ensure that the financial situation of the CBE will not deteriorate further in the short term, including the strengthening of the credit approval and monitoring process at the CBE, transferring the lending authority from the Board to management and creating an audit committee of the Board to oversee financial performance of CBE as soon as possible, reducing deposit rates, and prohibiting lending to borrowers that have nonperforming loans of more than one year.

External sector and balance of payments outlook

23. **The balance of payments projections for 2001/02 and the medium term** have been updated, taking into account the most recent revisions of the WEO, the latest available information on coffee exports and food relief, the update of the debt sustainability analysis presented in the enhanced HIPC Initiative decision point document, and the impact of the events of September 11, 2001. The revised projections for 2001/02 show a widening of the external current account deficit (including official transfers) to 7.1 percent of GDP and a financing requirement, after Fund assistance and already secured bilateral debt relief and assistance, of US$312 million (equivalent to 4.7 percent of GDP). This financing requirement is to be closed by World Bank balance of payments' support lending (US$174 million), the African Development Bank (AfDB) (US$50 million), and the European Union (US$49 million), and by interim assistance under the enhanced HIPC Initiative (US$39 million). The external current account deficit is projected to narrow to 6.2 percent of GDP in 2002/03, and the financing requirement of US$267 million (3.7 percent of GDP) to be fully covered from the same sources.[21] The Paris Club is expected to provide a flow rescheduling on Cologne terms after the recent reaching of the enhanced HIPC Initiative decision point.

[21] Delivery of interim assistance under the enhanced HIPC Initiative is estimated at US$105 million in 2002/03.

24. The bilateral agreements following the Paris Club meeting on April 5, 2001 are being finalized, and progress is being made in the bilateral negotiations with non-Paris Club creditors. The authorities are to seek rescheduling of debt to non-Paris Club creditors on terms at least comparable to those given by the Paris Club. The staff urged the authorities to improve the debt-monitoring system and debt statistics, and encouraged them to formulate and implement a comprehensive debt-management strategy. Repayments to the Fund will remain relatively small in relation to projected exports of goods and services, and Ethiopia is expected to meet its future obligations in a timely manner (Table 8).

25. 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.[22] However, a few exchange restrictions that existed prior to the PRGF arrangement remain, and the staff encouraged the authorities to eliminate them and to accept the obligations of Article VIII, Sections 2, 3, and 4. The staff also urged the authorities to remove or replace with tariffs any remaining nontariff barriers.

26. **The government intends to reduce the simple average import tariff from the existing level of 19½ percent to 17½ percent by January 2003.**[23] It also intends to lower the maximum tariff from 40 percent, and reduce the number of bands from seven at present. The staff urged the authorities to reduce the highest rate to 30 percent and the number of bands to four. The extent of tariff reduction and simplification will take into account a study on effective protection to be carried out by March 2002.

27. **Understandings were also reached on the implementation of the recommendations made in the recent safeguards assessment of the NBE** (Appendix V). The submission by the Audit Services Corporation to the NBE's board of an unqualified audit of the NBE's financial statements is proposed as a performance criterion for March 2002. Technical assistance from the Fund will be needed to implement some of the other recommendations made in the safeguards assessment.

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[22] At the time of approval of the PRGF arrangement, the Board approved retention of the multiple currency practice that arose from the possibility of a spread of more than 2 percent between the buying rates at the auction. However, over the program period, this auction has not generated a spread of more than 2 percent.

[23] All export taxes have been eliminated, except for an export duty of 6.5 percent on coffee applicable only if prices exceed certain levels. This duty was no longer levied since May 2001 as prices fell below 105 cents/lb for washed coffee and 70 cents/lb for sundried coffee.

B. Social Policies and the PRSP

28. **The staff, in collaboration with the World Bank, assessed progress made in the preparation of a full PRSP**, which the authorities intend to complete by May or June 2002. An interministerial steering committee has been constituted, and it has shared with donors an action plan for the preparation of the PRSP. Wide-ranging consultations at the district, regional, and federal levels started in October. The staff reiterated the importance of preparing a carefully considered and high-quality PRSP. It emphasized the need for an in-depth analysis of growth and its links to poverty, the preparation of a full-fledged HIV/AIDS strategy, and a social impact analysis of key policies to be carried out with donor assistance (Box 2).

C. Other Structural Reforms

29. Progress is being made in implementing, with World Bank assistance, structural reforms that are conducive to growth and poverty reduction, including agricultural reform, export promotion, and the strengthening of the existing legal and regulatory framework, including a review of land lease policy (Box 4). The authorities are also implementing a civil service reform, which aims at reinforcing public sector capacity building for services delivery, and a privatization program, which aims at bringing 40 entities to the point of sale in 2001/02-2002/03, including in the food, agriculture, textile, construction, and tourism sectors. The authorities will also enhance public expenditure control, as well as the internal and external audit, including by making the Auditor General independent and by presenting audited, closed government accounts to the parliament for 1998/99, 1999/2000, and 2000/01.

D. Statistical Issues

30. **The mission urged the authorities to continue their efforts to improve the compilation of macroeconomic statistics on a timely basis.** The reconciliation of monetary and fiscal accounts, to be implemented with the help of technical assistance, was set as a benchmark for September 2002. Following technical assistance from the Fund, the authorities plan to publish by end-2001 a new consumer price index (CPI) series based on the results of the 1999/2000 Household Income and Consumption Expenditure Survey (Appendix IV). Moreover, following previous technical assistance, the national accounts series is being revised. Given that further technical assistance is needed to improve macroeconomic statistics, a multisector statistics mission from the Fund is expected to visit Addis Ababa to assist the authorities in their efforts to improve data compilation. In addition, work is being carried out, with the help of World Bank staff, to improve data on poverty and social indicators, and to monitor the output and outcomes of the poverty reduction programs.

Box 4. Ethiopia: Structural Conditionality Streamlining Assessment

Structural conditionality in the first annual program

The original program supported by the PRGF arrangement includes prior actions, structural performance criteria and benchmarks (EBS/01/6, 1/30/01, Table 2) related to (a) **improving monetary and exchange rate management**; (b) **implementing tax reforms**; and (c) **restructuring the financial sector**.

Status of structural conditionality under the first annual program

The status of structural conditionality benchmarks and performance criteria as of November 30, 2001 is presented in Appendix I, 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 a 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 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 September 11, 2001 events.

Structural conditionality in the second annual program

Conditionality under the second annual program (Appendix I, Table 3) relates to (a) **restructuring the financial sector**; (b) **enhancing the safeguards of the National Bank of Ethiopia**; and (c) **improving public expenditure management**.

Structural areas covered by World Bank lending and conditionality

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

- civil service reform, including approval of a Civil Service Law by the Council of Ministers; launch of a diagnostic survey of job classification and grading; completion of a labor market survey on wage differentials between private and public sector jobs; and introduction of a pilot software for a human resource management information system;
- public expenditure management, including completion of the review of sectoral development programs (SDPs) in education and health; submission of a report on implementation bottlenecks of SDPs; agreement on an action plan to improve the financial management information system; definition of an action plan for improving the accounting system; and establishment of interministerial committee to facilitate government-donor dialogue on public expenditure issues; and
- private sector development and export competitiveness, including establishment of an export promotion council; adoption of a voucher-based duty exemption scheme; amendment of the export credit guarantee scheme to allow participating banks to charge market interest rates, and limiting collateral requested; shifting price information responsibility from the National Bank of Ethiopia to the Export Promotion Agency; and recommending the use of competitive bidding procedures to procure fertilizer for distribution by the regions.

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, with the sale of seven public entities, for a total value of US2.2 million, in 2000/01. The authorities intend to complete the privatization program by bringing 118 entities to the point of sale by 2003/04.

E. PRGF Arrangememt Monitoring

31. The staff reached understanding with the authorities on performance criteria for end-March 2002, as well as quantitative benchmarks for July 7, 2002, and indicative targets for September 2002 were established (Appendix I, Table 2). Structural performance criteria and benchmarks through September 2002 were also set (Appendix I, Table 3). The third review, scheduled to be completed by July 31, 2002, will assess progress in policy implementation, reach understandings for the budget for 2002/03, and set performance criteria and benchmarks for the first half of the 2002/03 program year.

V. Staff Appraisal

32. **Performance under the first annual PRGF-supported program was broadly satisfactory** in the context of Ethiopia's progress toward peace with Eritrea, and despite a tense domestic political situation and deteriorating global economic environment. Real GDP growth and the external current account deficit for 2000/01 were in line with program projections, and inflation turned negative. The overall fiscal deficit for 2000/01 was much smaller than programmed, as a small shortfall in revenue was more than offset by lower spending, including on defense. Social spending was in line with projections.

33. Most performance criteria and benchmarks under the program through October 2001 were observed. The July 2001 benchmarks for the net domestic assets and net foreign assets of the NBE were missed owing to technical delays in the disbursement of external assistance. The adjusted performance criterion on the net domestic assets of the NBE for end-September 2001 was missed, for which the authorities have requested a waiver. Some delays were also encountered in implementing tax administration reforms.

34. The second annual program was formulated in the context of a difficult world economic environment, characterized by a continued deterioration of the terms of trade for Ethiopia and the impact of the events of September 11, 2001. Although the macroeconomic objectives for the medium term were revised, the program still aims at maintaining macroeconomic stability and reducing poverty by achieving a robust real GDP growth of close to 6 percent. Part of the adverse impact of the recent developments on the balance of payments is expected to be mitigated by the requested augmentation in access under the PRGF arrangement and by additional assistance from the World Bank. The target for the fiscal deficit under the program was also relaxed somewhat to accommodate fully the externally financed capital and poverty-targeted expenditures.

35. **Provided the PRGF-supported program continues to be implemented effectively, its revised objectives are likely to be achieved.** To this end, the authorities must guard against slippages during the program period. They will need to concentrate their efforts in three key areas.

36. **First, in the fiscal area, the authorities should persevere with their efforts to reorient budgetary resources from defense toward poverty alleviation outlays, and to**

implement tax reforms that lay the foundation for a strong revenue performance. In addition to the full-year impact of the tax measures adopted since January 2001, the sustained implementation of tax administration reforms, close monitoring of tax evasion, and collection of tax arrears will be critical to achieving the revenue target. The staff urges the authorities to implement without delays, and with Fund technical assistance, the further envisaged tax reforms, particularly those related to making the recently established large-taxpayer unit effective and to introducing the VAT by January 2003. On the spending side, the authorities' cautious stance will need to be maintained. The authorities should also proceed to improve substantially the planning, tracking, and reporting of public expenditures, especially poverty-targeted spending, at the federal, regional, and district levels, and to accelerate the implementation of sector development programs.

37. **Second, in the monetary and exchange areas, the authorities will need to implement the far-reaching reforms agreed upon to strengthen the financial sector and improve its competitiveness.** In this regard, the adoption and enforcement of a provisioning directive in line with international standards will be critical to improving the soundness and competitiveness of the banking system, as will allowing the new management of the CBE to operate on a commercial basis without governmental interference. For the financial sector reform to be successful, the staff urges the authorities to allow foreign bank entry (or, as a minimum, to begin by allowing foreign minority shareholding), push ahead with a genuine reform of the largest state-owned bank, the CBE (particularly to reduce its dominance), strengthen bank supervision, ensure greater autonomy of the NBE, and rehabilitate weak banks. However, the authorities remain unconvinced that foreign bank entry will be beneficial to Ethiopia. In line with their proposal, a workshop will be held in March 2002 to discuss the issue.

38. **Third, adherence to the agenda of structural reforms is essential.** The authorities, in consultation with the World Bank, should continue to implement key structural reforms, focusing on (a) public sector management, including civil service reform; (b) public expenditure policy; (c) private sector development, including improving the functioning of land markets; and (d) export competitiveness. The government should also pursue its privatization program and proceed with the preparation of a high-quality full PRSP, while ensuring the complete participation of civil society and development partners in the process.

39. **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 waiver for the nonobservance of the end-September 2001 performance criterion for the net domestic assets of the NBE and the augmentation of access (equivalent to SDR 13.37 million) be granted, and that the present review under the PRGF arrangement be completed.

Figure 1. Ethiopia: Selected Economic Indicators, 1997/98-2003/04 1/

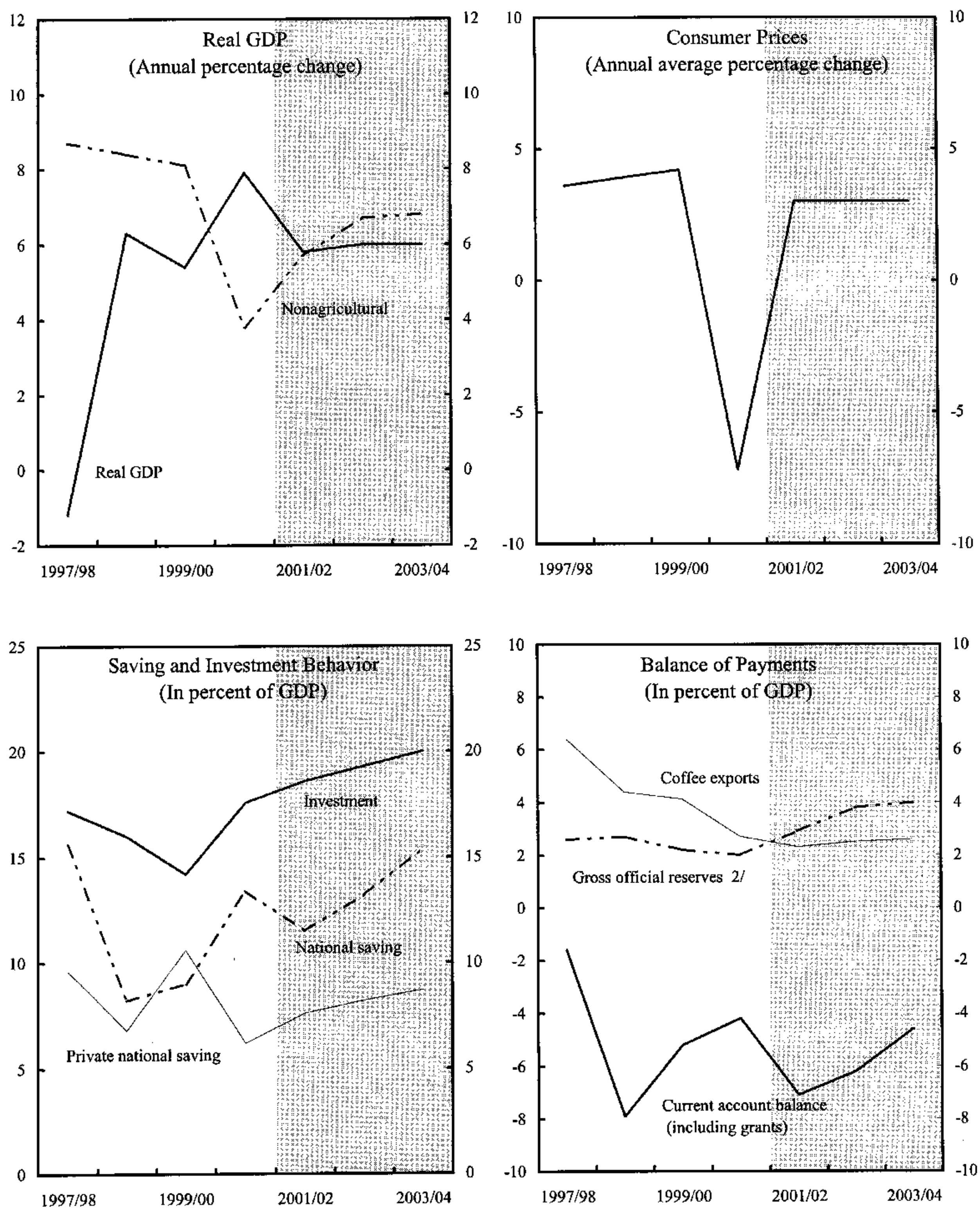
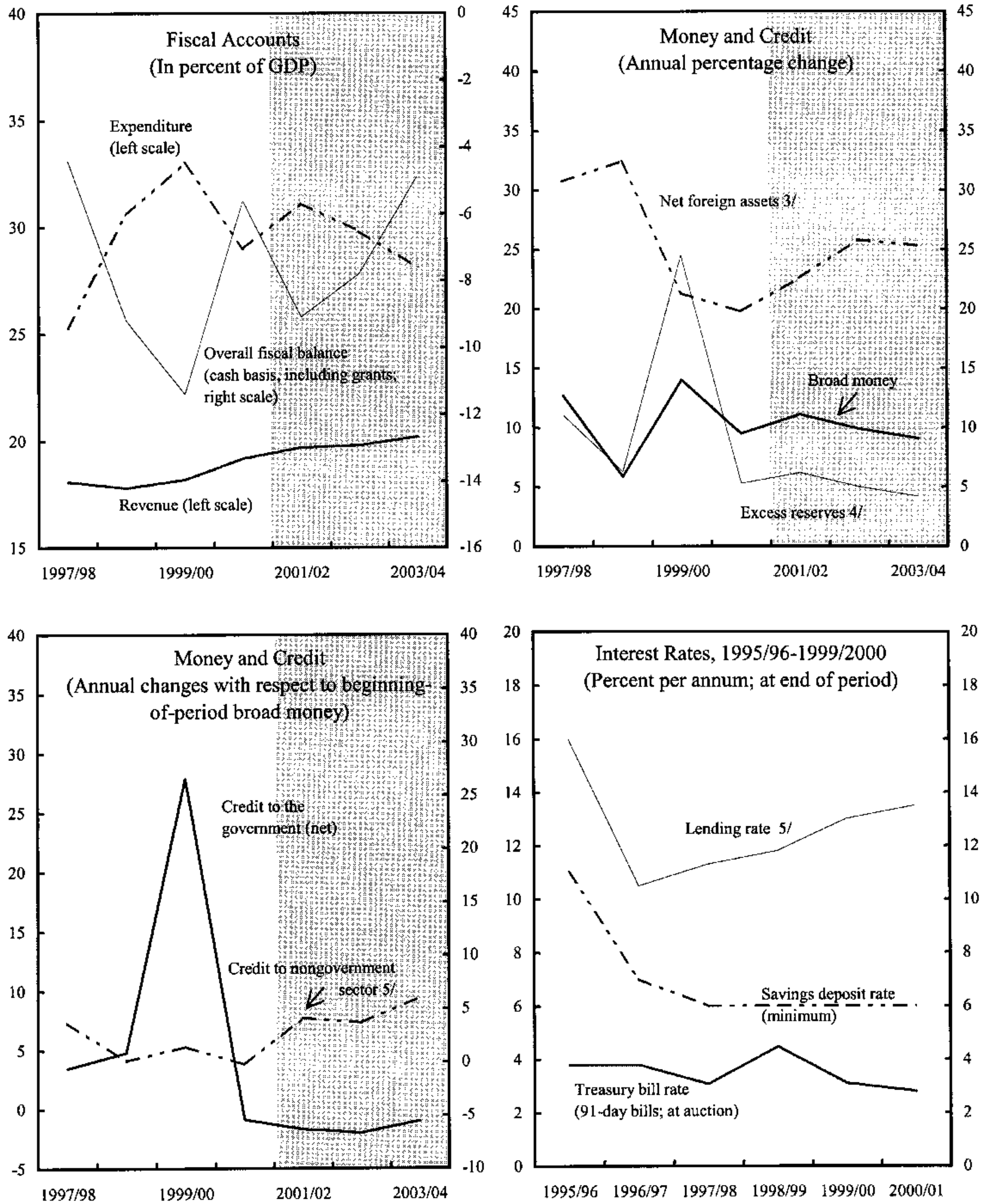


Figure 1. Ethiopia: Selected Economic Indicators, 1997/98-2003/04 1/ (concluded)

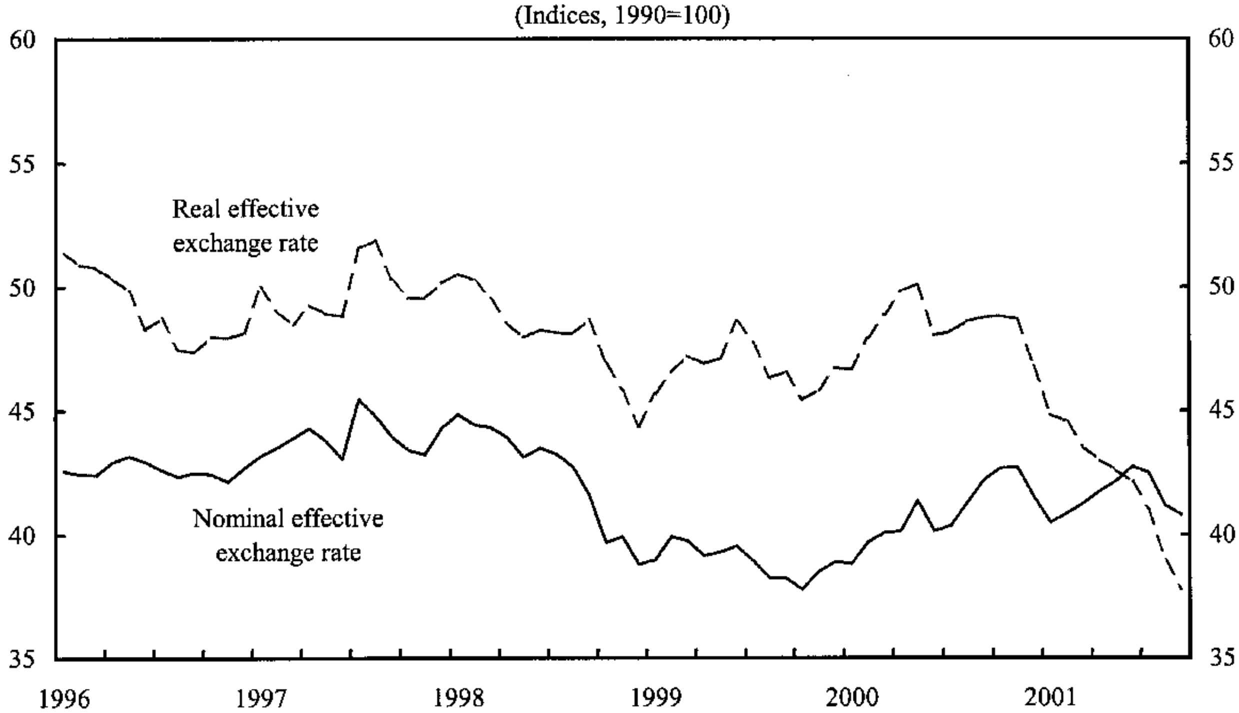


Sources: Ethiopian authorities; and staff estimates and projections.

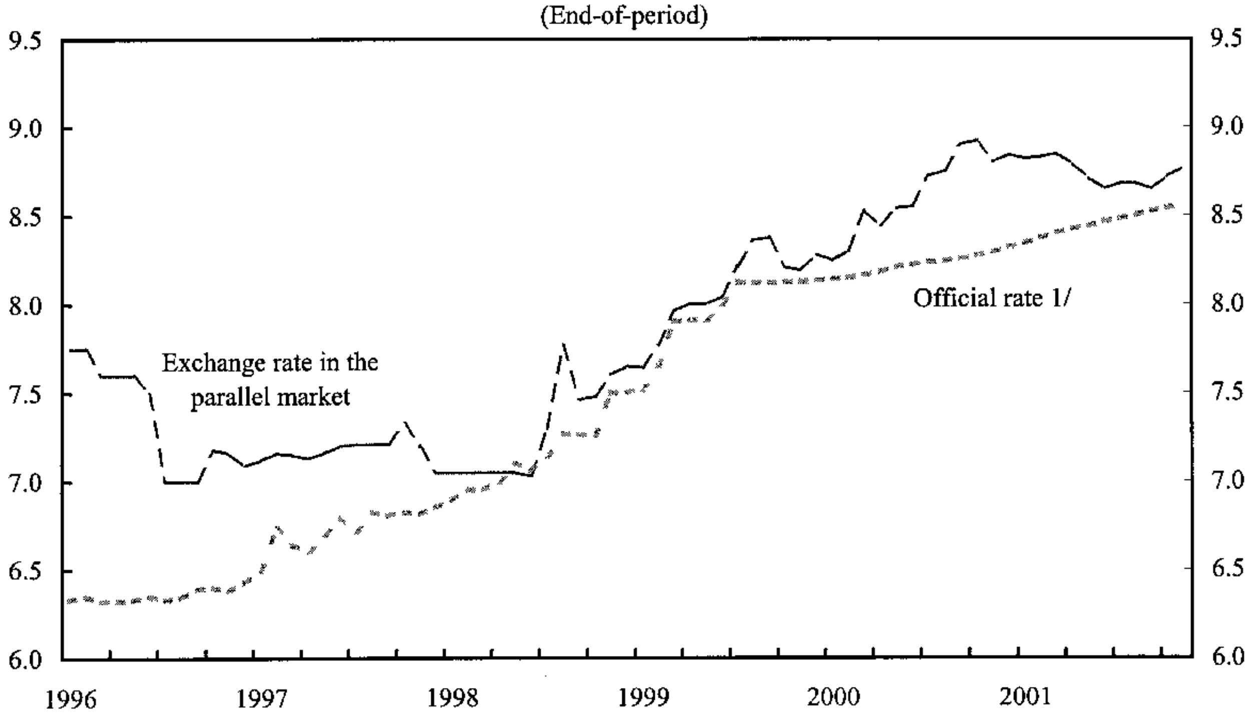
1/ All data pertain to the period July 8-July 7. Shaded area indicates program period.
2/ In months of imports of goods and nonfactor services of the following year.
3/ Change in percent of beginning-of-period broad money.
4/ In percent of deposits.
5/ Includes credit to public enterprises and the private sector.

Figure 2. Ethiopia: Exchange Rate Developments

Trade-Weighted Exchange Rates, January 1996-September 2001
(Indices, 1990=100)



Birr per U.S. Dollar Rates, January 1996-November 2001
(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, 2001-04

	Position on Oct. 31, 2001	2001	2002		2003		2004	
		Nov.-Dec.	Jan.-June	July-Dec.	Jan.-June	July-Dec.	Jan.-June	July-Dec.
				(In millions of SDRs)				
Net use of Fund resources								
Repayments	...	2.1	6.4	6.4	5.0	5.0	4.4	4.4
Projected disbursements	...	0.0	23.8	10.4	10.4	10.4	10.4	0.0
Fund resources outstanding (end of period)	86.2	84.0	101.4	105.4	110.8	116.3	122.3	118.0
				(In percent of quota) 1/				
Net use of Fund resources								
Repayments	...	1.6	4.8	4.8	3.7	3.7	3.3	3.3
Projected disbursements	...	0.0	17.8	7.8	7.8	7.8	7.8	0.0
Fund resources outstanding (end of period)	64.4	62.8	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: Proposed Schedule of Disbursements Under the PRGF Arrangement, 2001-04

	Amount		Avaliability	Conditions Include
	SDR	Percent of quota		
	17,381,000	13.0	March 2001	Board approval.
	17,381,000	13.0	July 2001	Completion of first review and observance of end-March 2001 performance criteria.
	23,799,000	17.8	January 2002	Completion of second review and observance of end-September 2001 performance criteria.
	10,429,000	7.8	July 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	July 2003	Completion of fifth review and observance of end-March 2003 performance criteria.
	10,429,000	7.8	January 2004	Completion of sixth review and observance of end-September 2003 performance criteria.
Total	100,277,000	75.0		

Source: Fund staff estimates and projections.

Table 3. Ethiopia: Selected Economic and Financial Indicators, 1997/98-2003/04 1/

	1997/98	1998/99	1999/00	2000/01		2001/02		2002/03	2003/04
				EBS/01/13	Estimate	EBS/01/108	Rev. Prog.	Rev. Projections	
				(Annual percentage change)					
National income and prices									
GDP at constant prices (at factor cost)	-1.2	6.3	5.4	7.8	7.9	7.0	5.8	6.0	6.0
GDP deflator (at factor cost)	9.9	1.9	0.9	3.2	-6.4	5.4	2.4	3.5	3.6
Consumer prices (period average)	3.6	3.9	4.2	5.2	-7.2	5.0	3.0	3.0	3.0
External sector									
Exports, f.o.b.	0.6	-19.6	0.4	-2.8	-9.3	9.3	-8.9	10.1	12.6
Imports, c.i.f.	3.6	14.8	3.4	-0.7	-3.3	5.1	2.6	3.8	5.1
Export volume	-9.7	-1.4	20.5	7.1	-1.8	6.8	0.2	7.5	7.0
Import volume	9.9	18.4	-17.9	-3.5	-2.5	7.1	5.3	5.0	4.0
Terms of trade (deterioration -)	18.1	-15.9	-33.9	-11.8	-6.8	4.2	-6.6	3.6	4.1
Nominal effective exchange rate (end of period)	1.0	-9.1	1.5	...	2.8	...	...	...	...
Real effective exchange rate (end of period)	-0.9	-1.0	-6.4	...	-1.2	...	...	...	...
		(In percent of beginning-period stock of broad money, unless otherwise indicated)							
Money and credit									
Net foreign assets	1.0	3.6	-8.1	7.9	0.3	6.0	5.3	5.8	1.8
Net domestic assets	11.7	2.3	22.1	4.6	9.2	5.1	5.7	4.2	7.3
Net claims on the government	3.5	4.8	27.9	-0.9	-0.9	-1.7	-1.7	-2.0	-1.0
Credit to the nongovernment sector	7.3	4.1	-5.3	9.3	3.8	9.8	7.7	7.3	9.4
Broad money	12.7	5.9	14.0	12.5	9.5	11.2	11.1	9.9	9.1
Velocity (GDP/broad money)	2.4	2.5	2.3	2.3	2.2	2.2	2.1	2.1	2.1
Interest rates (one-year maturity; in percent)									
Savings deposits (mandatory floor rate)	6.0	6.0	6.0	...	6.0	...	...	...	...
Lending rates	11.3	11.8	13.0	...	13.5	...	...	...	...
Treasury bill (91-day maturity)	3.1	4.5	3.1	...	2.8	...	...	...	...
			(In percent of GDP, unless otherwise indicated)						
Financial balances									
Gross domestic saving	7.7	1.2	-1.0	0.7	2.1	3.4	2.4	4.3	6.3
Government saving	3.3	-0.6	-4.9	0.0	2.1	2.4	0.5	2.0	3.7
Private saving	4.4	1.8	3.9	0.6	0.0	1.0	1.9	2.3	2.6
Gross domestic investment	17.2	16.0	14.2	17.0	17.6	19.2	18.6	19.3	20.0
Government investment	7.4	7.9	5.3	8.9	8.7	10.4	11.2	10.7	9.9
Private investment	9.8	8.2	9.0	8.1	8.9	8.8	7.5	8.7	10.1
Resource gap	-9.4	-14.8	-15.3	-16.4	-15.5	-15.8	-16.2	-15.0	-13.6
External current account balance, including official transfers	-1.6	-7.9	-5.2	-5.7	-4.2	-6.2	-7.1	-6.2	-4.6
Saving-investment (government)	-1.5	-6.5	-6.8	-4.9	-1.5	-4.9	-7.3	-5.6	-3.2
Saving-investment (private)	-0.1	-1.4	1.6	-0.8	-2.6	-1.3	0.2	-0.5	-1.4
External current account balance, excluding official transfers	-5.6	-11.2	-9.8	-10.7	-10.4	-10.3	-11.5	-10.2	-8.4
Government finances									
Revenue	18.1	17.8	18.2	18.8	19.2	19.2	19.7	19.8	20.2
Tax revenue	11.7	11.5	12.4	14.0	14.0	14.4	14.7	14.9	15.4
Nontax revenue	6.3	6.3	5.8	4.8	5.2	4.8	5.0	4.9	4.8
External grants	2.8	3.6	3.3	6.0	5.0	4.6	4.5	4.1	3.8
Expenditure and net lending 2/	25.3	30.6	33.0	31.2	29.0	29.1	31.1	29.8	28.1
Fiscal balance, excluding grants (cash basis) 2/	-7.2	-12.9	-14.8	-12.4	-9.8	-10.0	-11.4	-9.9	-7.9
Fiscal balance, including grants (cash basis) 2/	-4.4	-9.2	-11.4	-6.4	-4.8	-5.4	-6.9	-5.9	-4.1
Special programs 3/	0.0	0.0	0.0	1.9	0.8	2.9	2.2	1.9	0.8
Fiscal balance, including grants and special programs	-4.4	-9.2	-11.4	-8.4	-5.6	-8.2	-9.1	-7.8	-4.9
Total financing	4.4	9.2	11.4	8.4	5.6	8.2	9.1	7.8	4.9
External financing	1.7	3.5	1.7	7.1	3.9	7.6	8.4	7.5	4.2
Domestic financing (including residual)	1.9	4.1	8.6	0.4	0.9	0.0	0.0	-0.2	0.3
Privatization receipts	0.7	1.6	1.2	0.9	0.8	0.7	0.7	0.6	0.4
Domestic debt	29.0	31.2	42.2	38.0	40.3	35.9	...	...	...
External debt (including to Fund) 4/	78.5	82.4	85.3	88.8	88.3	89.1	91.6	90.0	83.8
External debt-service ratio 5/	57.7	63.3	52.2	22.4	23.2	20.0	22.7	20.6	18.8
Overall balance of payments (in millions of U.S. dollars)	-507	-473	-366	-202	-52	-257	40	-93	-118
Gross official reserves (in millions of U.S. dollars)	412	434	349	435	337	637	495	678	746
(in months of imports of goods and nonfactor services of follow. year)	2.6	2.7	2.2	2.5	2.0	3.5	2.9	3.8	4.0
GDP at current market prices (in millions of birr)	44,840	48,688	52,074	57,746	53,011	60,039	57,496	62,845	70,018
Exchange rate (birr per U.S. dollar; period average auction rate)	6.86	7.53	8.15	...	8.34	...	...	...	...

Sources: Ethiopian authorities; and staff estimates.

1/ Beginning 1997/98, all data pertain to the period July 8-July 7; prior to that, fiscal and monetary data cover the period July 8-July 7 and all other data the period July 1-June 30.
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, 1997/98-2003/04 1/
(In millions of birr)

	1997/98	1998/99	1999/00	2000/01		2001/02		2002/03	2003/04
				EBS/01/13	Estimate	EBS/01/108	Rev. Prog.	Rev. Projection	
Total revenue and grants	9,374	10,415	11,222	14,273	12,819	14,267	13,894	15,016	16,815
Revenue	8,100	8,653	9,498	10,828	10,191	11,506	11,306	12,459	14,143
Tax revenue (incl. measures)	5,269	5,592	6,482	8,061	7,446	8,646	8,446	9,362	10,783
Direct taxes	1,869	2,009	2,367	2,930	2,737	3,512	3,447	3,856	4,510
Indirect taxes	3,399	3,583	4,116	5,131	4,709	5,134	4,999	5,506	6,272
Domestic indirect taxes	1,181	1,204	1,440	1,760	1,385	1,830	1,775	2,045	2,409
Import duties and taxes	2,037	2,223	2,528	3,195	3,231	3,252	3,182	3,417	3,815
Export taxes	181	155	148	176	93	52	42	44	48
Nontax revenue	2,832	3,062	3,016	2,767	2,745	2,860	2,860	3,096	3,360
Grants	1,273	1,762	1,724	3,445	2,628	2,761	2,587	2,558	2,672
Total expenditure and net lending (cash basis) 2/	11,328	14,916	17,184	17,994	15,370	17,485	17,856	18,697	19,704
Recurrent expenditure 2/	7,081	10,126	13,742	12,439	10,352	11,462	11,366	11,834	12,352
Defense spending	2,190	4,233	6,842	4,204	3,307	3,300	3,000	2,824	2,650
Poverty-targeted expenditure	2,074	2,301	2,324	2,932	2,738	3,143	3,320	3,686	4,207
Of which: HIPC poverty-targeted expenditure	0	0	0	0	0	21	17	47	40
Interest payments (after traditional debt-relief mechanism)	836	957	1,122	1,416	1,080	1,183	1,248	1,280	1,314
Domestic interest and charges	526	588	723	749	575	679	669	682	695
External interest payments (after traditional debt-relief mechanism)	310	369	399	667	505	504	579	598	619
External assistance (food and other emergency aid)	160	813	1,289	1,317	978	1,027	782	876	886
Other	1,822	1,823	2,164	2,570	2,249	2,809	3,017	3,168	3,295
Net lending	100	0	0	0	0	0	0	0	0
Capital expenditure 2/	4,147	4,790	3,442	5,555	5,018	6,023	6,489	6,864	7,352
Of which: poverty-targeted expenditure	2,334	2,853	2,031	4,382	3,049	4,238	5,220	5,668	6,035
Of which: HIPC poverty-targeted expenditure	0	0	0	0	0	408	317	886	766
Balance, excl. special programs (cash basis)									
Including grants	-1,954	-4,501	-5,961	-3,721	-2,552	-3,219	-3,962	-3,681	-2,889
Excluding grants	-3,228	-6,263	-7,685	-7,166	-5,180	-5,979	-6,549	-6,238	-5,561
Special programs 3/	0	0	0	1,114	404	1,715	1,287	1,210	565
Overall balance									
Including grants	**-1,954**	**-4,501**	**-5,961**	**-4,835**	**-2,955**	**-4,934**	**-5,249**	**-4,891**	**-3,454**
Excluding grants	-3,228	-6,263	-7,685	-8,280	-5,583	-7,695	-7,837	-7,448	-6,125
Financing	1,954	4,501	5,961	4,835	2,955	4,934	5,249	4,891	3,454
External (net)	780	1,708	868	4,089	2,070	4,534	4,849	4,698	3,072
Gross borrowing	1,122	2,143	1,366	4,858	2,686	4,755	5,103	4,563	3,072
HIPC Initiative relief	0	0	0	0	0	429	334	932	806
Amortization repayment (after traditional debt-relief mechanism)	341	434	498	769	616	650	588	797	807
Domestic(net)	592	1,515	4,975	246	57	0	0	-157	81
Banking system	575	885	5,499	-195	-213	-422	-422	-534	-314
Nonbank sources	17	629	-524	441	270	422	422	377	396
Privatization	313	800	650	500	400	400	400	350	300
Float/unidentified financing	270	478	-532	0	429	0	0	0	0
Memorandum items:									
HIPC Initiative relief on interest	0	0	0	0	0	250	235	468	328
HIPC Initiative relief on amortization	0	0	0	0	0	179	99	462	479
GDP	44,840	48,688	52,074	57,746	53,011	60,039	57,496	62,845	70,018

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, 1997/98-2003/04 1/
(In percentage of GDP)

	1997/98	1998/99	1999/00	2000/01		2001/02		2002/03	2003/04
				EBS/01/13	Estimate	EBS/01/108	Rev. Prog.	Rev. Projection	
Total revenue and grants	20.9	21.4	21.6	24.7	24.2	23.8	24.2	23.9	24.0
Revenue	18.1	17.8	18.2	18.8	19.2	19.2	19.7	19.8	20.2
Tax revenue (incl. measures)	11.7	11.5	12.4	14.0	14.0	14.4	14.7	14.9	15.4
Direct taxes	4.2	4.1	4.5	5.1	5.2	5.8	6.0	6.1	6.4
Indirect taxes	7.6	7.4	7.9	8.9	8.9	8.6	8.7	8.8	9.0
Domestic indirect taxes	2.6	2.5	2.8	3.0	2.6	3.0	3.1	3.3	3.4
Import duties and taxes	4.5	4.6	4.9	5.5	6.1	5.4	5.5	5.4	5.4
Export taxes	0.4	0.3	0.3	0.3	0.2	0.1	0.1	0.1	0.1
Nontax revenue	6.3	6.3	5.8	4.8	5.2	4.8	5.0	4.9	4.8
Grants	2.8	3.6	3.3	6.0	5.0	4.6	4.5	4.1	3.8
Total expenditure and net lending (cash basis) 2/	25.3	30.6	33.0	31.2	29.0	29.1	31.1	29.8	28.1
Recurrent expenditure 2/	15.8	20.8	26.4	21.5	19.5	19.1	19.8	18.8	17.6
Defense spending	4.9	8.7	13.1	7.3	6.2	5.5	5.2	4.5	3.8
Poverty-targeted expenditure	4.6	4.7	4.5	5.1	5.2	5.2	5.8	5.9	6.0
Of which: HIPC poverty-targeted expenditure	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.1
Interest payments (after traditional debt-relief mechanism)	1.9	2.0	2.2	2.5	2.0	2.0	2.2	2.0	1.9
Domestic interest and charges	1.2	1.2	1.4	1.3	1.1	1.1	1.2	1.3	1.0
External interest payments (after traditional debt-relief mechanism)	0.7	0.8	0.8	1.2	1.0	0.8	1.0	1.0	0.9
External assistance (food and other emergency aid)	0.4	1.7	2.5	2.3	1.8	1.7	1.4	1.4	1.3
Other	4.1	3.7	4.2	4.4	4.2	4.7	5.2	5.0	4.7
Net lending	0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Capital expenditure 2/	9.2	9.8	6.6	9.6	9.5	10.0	11.3	10.9	10.5
Of which: poverty-targeted expenditure	5.2	5.9	3.9	7.6	5.8	7.1	9.1	9.0	8.6
Of which: HIPC poverty-targeted expenditure	0.0	0.0	0.0	0.0	0.0	0.7	0.6	1.4	1.1
Balance, excl. special programs (cash basis)									
Including grants	-4.4	-9.2	-11.4	-6.4	-4.8	-5.4	-6.9	-5.9	-4.1
Excluding grants	-7.2	-12.9	-14.8	-12.4	-9.8	-10.0	-11.4	-9.9	-7.9
Special programs 3/	0.0	0.0	0.0	1.9	0.8	2.9	2.2	1.9	0.8
Overall balance									
Including grants	-4.4	-9.2	-11.4	-8.4	-5.6	-8.2	-9.1	-7.8	-4.9
Excluding grants	-7.2	-12.9	-14.8	-14.3	-10.5	-12.8	-13.6	-11.9	-8.7
Financing	4.4	9.2	11.4	8.4	5.6	8.2	9.1	7.8	4.9
External (net)	1.7	3.5	1.7	7.1	3.9	7.6	8.4	7.5	4.4
Gross borrowing	2.5	4.4	2.6	8.4	5.1	7.9	8.9	7.3	4.4
HIPC Initiative relief	0.0	0.0	0.0	0.0	0.0	0.7	0.6	1.5	1.2
Amortization repayment (after traditional debt-relief mechanism)	0.8	0.9	1.0	1.3	1.2	1.1	1.0	1.3	1.2
Domestic(net)	1.3	3.1	9.6	0.4	0.1	0.0	0.0	-0.2	0.1
Banking system	1.3	1.8	10.6	-0.3	-0.4	-0.7	-0.7	-0.8	-0.4
Nonbank sources	0.0	1.3	-1.0	0.8	0.5	0.7	0.7	0.6	0.6
Privatization	0.7	1.6	1.2	0.9	0.8	0.7	0.7	0.6	0.4
Float/unidentified financing	0.6	1.0	-1.0	0.0	0.8	0.0	0.0	0.0	0.0
Memorandum items:									
HIPC Initiative relief on interest	0.0	0.0	0.0	0.0	0.0	0.4	0.4	0.7	0.5
HIPC Initiative relief on amortization	0.0	0.0	0.0	0.0	0.0	0.3	0.2	0.7	0.7

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, 1997/98-2003/04 1/

	1997/98	1998/99	1999/00	2000/01		2001/02		2002/03	2003/04
				EBS/01/13	Actual	EBS/01/108	Rev. Prog.	Rev. Projections	
	(In millions of Birr)								
Net foreign assets (at current exchange rate)	5,724	6,388	4,783	6,560	4,861	7,263	6,173	7,753	8,299
National Bank of Ethiopia (NBE)	1,963	2,374	1,929	2,779	1,661	3,986	2,888	4,424	4,935
Assets	2,918	3,527	2,870	4,191	2,857	5,538	4,308	5,977	6,647
Liabilities	955	1,153	941	1,412	1,196	1,551	1,419	1,553	1,712
Commercial banks	3,761	4,014	2,854	3,782	3,200	3,276	3,285	3,329	3,364
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
Assets	5,847	5,735	4,957	6,243	5,125	5,229	5,262	5,331	5,389
Of which									
Deposits with Eritrean banks	2,370	2,370	2,370	2,370	2,370	2,370	2,370	2,370	2,370
Liabilities	2,086	1,722	2,104	2,461	1,925	1,953	1,977	2,003	2,024
Of which									
Liabilities to Eritrean banks	1,137	1,137	1,137	1,137	1,137	1,137	1,137	1,137	1,137
Net domestic assets	12,891	13,317	17,674	18,707	19,740	19,614	21,153	22,290	24,469
Domestic credit	18,930	20,577	27,114	29,015	27,764	29,227	29,246	30,703	33,219
Claims on government (net) 2/	9,372	10,258	15,757	15,564	15,544	14,680	15,123	14,589	14,274
NBE	8,126	8,275	14,000	11,003	9,850	9,705	9,428	8,894	8,380
Commercial banks	1,246	1,982	1,757	4,561	5,695	4,975	5,695	5,695	5,895
Claims on other sectors	9,558	10,320	11,357	13,451	12,220	14,547	14,124	16,115	18,944
NBE	465	465	394	394	394	394	394	394	394
Commercial banks	9,093	9,855	10,963	13,057	11,826	14,153	13,730	15,721	18,550
Other items (net)	-6,039	-7,260	-9,440	-10,308	-8,024	-9,613	-8,094	-8,413	-8,749
Broad money	18,615	19,704	22,456	25,267	24,598	26,877	27,326	30,042	32,769
Money	10,965	11,658	13,265	14,651	13,778	15,158	15,462	16,795	17,686
Currency outside banks	4,750	5,220	5,923	6,560	5,930	6,955	6,513	7,192	6,753
Demand deposits	6,215	6,438	7,343	8,091	7,848	8,203	8,950	9,603	10,933
Quasi money	7,650	8,047	9,191	10,616	10,820	11,718	11,864	13,248	15,083
Savings deposits	6,485	7,204	8,356	9,238	9,824	10,686	10,823	12,023	13,688
Time deposits	1,166	843	835	1,378	996	1,033	1,041	1,225	1,395
	(Annual change in percent of beginning-period broad money; unless otherwise indicated)								
Net foreign assets	1.0	3.6	-8.1	7.9	0.3	6.0	5.3	5.8	1.8
Net domestic assets	11.7	2.3	22.1	4.6	9.2	5.1	5.7	4.2	7.3
Domestic credit	10.8	8.8	33.2	8.5	2.9	8.1	6.0	5.3	8.4
Claims on government (net)	3.5	4.8	27.9	-0.9	-0.9	-1.7	-1.7	-2.0	-1.0
Claims on other sectors	7.3	4.1	5.3	9.3	3.8	9.8	7.7	7.3	9.4
Broad money	12.7	5.9	14.0	12.5	9.5	11.2	11.1	9.9	9.1
Money	6.0	3.7	8.2	6.2	2.3	4.4	6.8	4.9	3.0
Quasi money	6.8	2.1	5.8	6.3	7.3	6.7	4.2	5.1	6.1
Memorandum items:									
Quasi money/broad money (in percent)	41.1	40.8	40.9	42.0	44.0	43.6	43.4	44.1	46.0
Velocity (GDP/broad money)	2.41	2.47	2.32	2.29	2.16	2.20	2.10	2.09	2.14
Gross official foreign reserves (in millions of U.S. dollars)	412	434	349	435	337	637	495	678	746
Net foreign assets of the banking system (in millions of U.S. dollars)	808	787	581	681	574	835	710	880	932
Excess reserves (in percent of deposits)	11.1	6.3	24.5	5.0	5.3	5.7	6.2	5.0	4.2

Sources: Ethiopian authorities; 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, 1997/98-2005/06 1/
(In millions of U.S. dollars, unless otherwise indicated)

	1997/98	1998/99	1999/00	2000/01		2001/02		2002/03	2003/04	2004/05	2005/06
				EBS/01/13	Estimate	EBS/01/108	Rev. Prog.	Revised Projections			
Trade balance	-755	-1,074	-1,125	-1,247	-1,117	-1,232	-1,197	-1,216	-1,245	-1,259	-1,310
Exports of goods	602	484	486	476	441	489	402	442	498	576	639
Coffee	420	281	262	209	175	192	155	178	203	238	284
Other	182	203	224	267	266	297	247	264	294	338	355
Imports of goods	1,357	1,558	1,611	1,723	1,558	1,721	1,598	1,658	1,742	1,835	1,949
Fuel	143	111	250	265	292	243	247	236	245	261	278
Nonfuel	1,213	1,447	1,361	1,458	1,266	1,478	1,351	1,422	1,497	1,573	1,671
Nonfactor services (net)	139	114	149	191	129	128	114	137	167	185	206
Exports of nonfactor services	435	430	498	514	516	530	494	524	565	599	642
Imports of nonfactor services	296	315	349	323	387	402	380	387	399	415	435
Income (net)	-66	-52	-60	-51	-51	-37	-50	-42	-33	-25	-19
Of which : gross official interest payments 2/	-89	-82	-76	-70	-70	-68	-71	-72	-71	-71	-70
Private transfers (net)	317	289	410	417	379	419	362	393	445	481	532
Current account balance, excl. official transfers	-365	-723	-626	-690	-659	-721	-771	-729	-666	-618	-592
(in percent of GDP)	-5.6	-11.2	-9.8	-10.7	-10.4	-10.3	-11.5	-10.2	-8.4	-7.2	-6.3
Official transfers (net)	261	213	291	325	395	289	296	288	304	329	326
Current account balance, incl. official transfers	-104	-510	-335	-365	-264	-432	-475	-442	-362	-289	-266
(in percent of GDP)	-1.6	-7.9	-5.2	-5.7	-4.2	-6.2	-7.1	-6.2	-4.6	-3.4	-2.9
Capital account balance (incl. errors and ommissions)	-403	37	-31	162	212	175	516	349	244	242	230
Foreign direct investment (net)	7	136	51	50	52	43	40	60	70	80	80
Other investment (net)	-350	-281	-30	112	207	132	476	289	174	162	150
Official long-term loans	-333	-263	-10	127	194	144	489	306	191	174	162
Disbursements 3/	151	212	182	252	320	253	594	402	292	281	273
Amortization 2/	485	474	191	125	126	109	105	96	101	107	111
Other public sector long-term (net) 4/	-17	-18	-20	-15	-14	-12	-13	-17	-16	-12	-12
Other (net)	0	0	130	0	26	0	0	0	0	0	0
Errors and omissions	-60	182	-183	0	-73	0	0	0	0	0	0
Overall balance	-507	-473	-366	-202	-52	-257	40	-93	-118	-47	-36
Financing	507	473	366	202	52	257	-40	93	118	47	36
Central bank (net; increase -)	146	-15	44	-54	39	-150	-136	-170	-52	-107	-118
Reserves (increase -)	171	-23	63	-87	12	-185	-158	-183	-68	-98	-111
Liabilities (increase +)	-25	8	-19	32	27	35	22	13	15	-9	-7
Fund credit (net)	-6	14	-12	32	10	0	22	13	15	-9	-7
Commercial banks (net; increase -)	-136	36	181	-46	-26	0	0	0	0	0	0
Changes in arrears	52	122	40	-810	-810	0	0	0	0	0	0
Debt relief (Paris Club II and III, Naples terms) 5/	445	330	101	0	849	0	40	37	18	0	0
Financing gap	0	0	0	1,113	0	407	56	226	152	154	154
Exceptional financing 6/	0	0	0	269	0	300	17	120	55	55	55
Traditional debt relief 7/	0	0	0	844	0	55	0	0	6	21	20
HIPC relief 8/	0	0	0	0	0	52	39	105	91	78	80
Residual after HIPC	0	0	0	0	0	0	0	0	0	0	0
Memorandum items:											
Exports of goods (percent change)	0.6	-19.6	0.4	-2.8	-9.3	9.3	-8.9	10.1	12.6	15.7	10.9
Export price index (percent change)	11.4	-18.5	-16.7	-9.2	-7.6	2.4	-9.1	2.4	5.2	7.1	2.7
Export volume index (percent change)	-9.7	-1.4	20.5	7.1	-1.8	6.8	0.2	7.5	7.0	8.0	8.0
Total imports of goods (percent change)	3.6	14.8	3.4	-0.7	-3.3	5.1	2.6	3.8	5.1	5.3	6.2
Import price index (percent change)	-5.7	-3.0	25.9	2.9	-0.8	-1.7	-2.7	-1.2	1.1	1.0	1.0
Import volume index (percent change)	9.9	18.4	-17.9	-3.5	-2.5	7.1	5.3	5.0	4.0	4.2	5.2
Gross official reserves	412	434	349	435	337	637	495	678	746	844	955
(in months of imports of goods and nonfactor services of following year)	2.6	2.7	2.2	2.5	2.0	3.5	2.9	3.8	4.0	4.2	4.5
Terms of trade index (1996/97 = 100)	118.1	99.3	65.6	69.6	61.2	72.9	57.1	59.2	61.6	65.4	66.5
(percent change)	18.1	-15.9	-33.9	-11.8	-6.8	4.2	-6.6	3.6	4.1	6.0	1.7

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

1/ Beginning in 1997/98, all data pertain to the period July 8-July 7; prior to that, data cover the period July 1-June 30.
2/ Includes debt service to Russia on ruble-denominated debt before up-front discount through 1999/2000; thereafter, after up-front discount.
3/ Projections now include loans previoulsy shown as exceptional financing.
4/ Ethiopian Airlines and other public enterprises.
5/ Includes 1997 Paris Club rescheduling agreement (including Russia) under Naples terms, covering maturities through end-1998.
6/ World Bank Economic Structural Adjustment Credit and increase in access by 10 percent of quota under the IMF's Poverty Reduction and Growth Facility arrangement.
7/ Beyond 2002/03, attributable to the Naples stock-of-debt operation expected at the enhanced HIPC Initiative completion point.
8/ Interim enhanced HIPC Initiative assistance upto the completion point, and enhanced HIPC assistance thereafter.

Table 8. Ethiopia: Projected Payments to the Fund, 2001/02-2011/12 1/
(In millions of SDRs, unless otherwise indicated)

	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12
Obligations from existing drawings	9.2	12.1	10.0	7.9	6.4	10.1	10.3	8.8	7.3	7.3	1.3
PRGF/ESAF/SAF repayments	8.5	11.4	9.4	7.3	5.9	9.6	9.9	8.4	7.0	7.0	1.0
Charges and interest 2/	0.6	0.6	0.6	0.5	0.5	0.5	0.4	0.4	0.3	0.3	0.3
On Fund credit	0.4	0.4	0.3	0.3	0.2	0.2	0.1	0.1	0.1	0.0	0.0
On use of SDRs	0.2	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/	0.0	0.2	0.3	0.3	0.3	0.3	6.1	10.2	13.3	13.2	14.2
PRGF/ESAF/SAF repayments	0.0	0.0	0.0	0.0	0.0	0.0	5.8	10.0	13.1	13.1	13.1
Charges and interest 2/	0.0	0.2	0.3	0.3	0.3	0.3	0.3	0.3	0.2	0.1	1.1
On Fund credit	0.0	0.2	0.3	0.3	0.3	0.3	0.3	0.3	0.2	0.1	0.1
On use of SDRs	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	1.0
Total obligations 3/	9.2	12.2	10.2	8.2	6.7	10.4	16.4	19.0	20.6	20.5	15.5
PRGF/ESAF/SAF repayments	8.5	11.4	9.4	7.3	5.9	9.6	15.7	18.4	20.1	20.1	14.1
Charges and interest 2/	0.7	0.8	0.9	0.9	0.8	0.8	0.7	0.6	0.5	0.4	1.4
On Fund credit	0.5	0.5	0.6	0.6	0.6	0.5	0.5	0.4	0.3	0.2	0.1
On use of SDRs	0.2	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	1.3
Outstanding Fund credit 3/ 4/	101.4	110.8	122.3	115.0	109.1	99.5	83.8	65.4	45.3	25.3	11.2
In percent of:											
Exports of goods and nonfactor services	11.3	11.5	11.5	9.8	8.5	7.1	5.5	3.9	2.5	1.3	0.5
External public debt	1.7	1.7	1.8	1.7	1.6	1.4	1.2	0.9	0.6	0.4	0.2
Gross official reserves	20.5	16.3	15.9	13.2	11.1	10.5	8.2	6.0	3.3	1.7	0.7
GDP	1.5	1.5	1.5	1.3	1.2	0.9	0.7	0.5	0.3	0.2	0.1
Quota	75.8	82.9	91.5	86.0	81.6	74.4	62.7	48.9	33.9	18.9	8.4
Total obligations	9.2	12.2	10.2	8.2	6.7	10.4	16.4	19.0	20.6	20.5	15.5
In percent of:											
Exports of goods and nonfactor services	1.0	1.3	1.0	0.7	0.5	0.7	1.1	1.2	1.1	1.0	0.7
External public debt	0.2	0.2	0.2	0.1	0.1	0.2	0.2	0.3	0.3	0.3	0.2
Gross official reserves	1.9	1.8	1.3	0.9	0.7	1.1	1.6	1.7	1.5	1.4	0.9
GDP	0.1	0.2	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Quota	6.9	9.2	7.7	6.1	5.0	7.8	12.3	14.2	15.4	15.3	11.6
Memorandum item:											
Projected disbursements	23.8	20.9	20.9	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) will take place 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					
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 population)	482	491	567	499	288
Female (per thousand population)	411	401	523	453	258

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

December 31, 2001

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

Dear Mr. Köhler:

1. Following the end of the border conflict with Eritrea in 2000, the government of Ethiopia resumed its economic reform efforts and renewed its commitment to poverty reduction within a framework of macroeconomic stability, as laid out in its interim poverty reduction strategy paper of November 2000. These reform efforts are supported by the International Monetary Fund (IMF) under a three-year Poverty Reduction and Growth Facility (PRGF) arrangement approved on March 22, 2001.

2. In accordance with the provisions of the arrangement, the government of Ethiopia, in cooperation with staff of the IMF, has evaluated the implementation of the first annual program (October 2000–September 2001). The attached memorandum on economic and financial policies (MEFP) also presents the government's objectives and policies for the second annual program (October 2001–September 2002), in line with the MEFP for 2000/01–2002/03, dated January 29, 2001, and the letter of intent, dated May 29, 2001. The government intends to make the contents of this letter, and those of the attached MEFP and technical memorandum of understanding, available to the public and authorizes you to arrange for them to be posted on the IMF website, subsequent to Executive Board completion of the second review under the PRGF arrangement.

3. As you will appreciate, performance under the first annual program was broadly satisfactory, notwithstanding delays in the disbursement of external financial assistance, and continued deterioration of the terms of trade. Most quantitative and structural performance criteria and benchmarks through end-September 2001 were observed, except for the July 7, 2001 benchmarks for net foreign assets (NFA) and net domestic assets (NDA) of the National Bank of Ethiopia (NBE), which were missed because external assistance was delayed by a few days for technical reasons. Calculations indicate that both benchmarks would have been observed with large margins if these funds had been disbursed as originally anticipated. Also, the performance criterion on the NDA of the NBE for end-September 2001 was missed, and the government of Ethiopia requests a waiver for its nonobservance in view of the fact that the program remains on track, as outlined in the attached memorandum. The government is determined to meet all subsequent performance criteria and benchmarks. Following the completion of the second review under the PRGF arrangement by the Executive Board, the government requests the third disbursement of SDR 10.429 million under the arrangement.

4. The second annual program was formulated in the context of a difficult world economic environment characterized by continued deterioration of the terms of trade for Ethiopia, which is further adversely affected by the events of September 11, 2001. In the face

of these developments, the government is determined to pursue a restrained fiscal stance and a cautious monetary policy. However, real GDP growth and foreign reserve targets had to be revised downward. To mitigate the impact of the recent events on the balance of payments, the government requests an increase in access under the PRGF arrangement of 10 percent of quota (about US$17 million), to be disbursed at the completion of the second review of the PRGF-supported program. The government also requested an increase in disbursement of balance of payments support from the World Bank of around US$20 million.

5. To monitor progress in economic policy implementation, financial and structural benchmarks through end-September 2002 and performance criteria for end-March 2002 under the second annual program are summarized in the tables annexed to the MEFP. The third review under the PRGF arrangement is scheduled to be completed by end-July 2002 and will, inter alia, consider the budgetary policy framework for 2002/03. At that time, the performance criteria for end-September 2002 will be established. A fourth review, which will assess progress in policy implementation, describe the third annual program, and set performance criteria and benchmarks for the third annual program, is scheduled to be completed by end-January 2003. The fifth and final review under the arrangement is scheduled to take place by end-July 2003. The government of Ethiopia will provide the Fund with such information as the Fund requests in connection with the country's progress in implementing the economic and financial policies and achieving the objectives of the program.

6. The government believes that the policies and measures set forth in the attached memorandum are adequate to achieve the objectives of the program. During the period of the arrangement, the government stands ready to take additional measures that may become appropriate for the achievement of the objectives of the program. We will consult with the Managing Director of the IMF on the adoption of any measures that may be appropriate, at the initiative of the government of Ethiopia or whenever the Managing Director requests such consultation. Moreover, after the period of the arrangement and while Ethiopia has outstanding financial obligations arising from loans under the arrangement, Ethiopia will consult the IMF from time to time at the initiative of the government of Ethiopia or whenever the Managing Director requests such consultation.

Sincerely yours,

/s/

Sufian Ahmed
Minister of Finance and
Economic Development

/s/

Teklewold Atnafu
Governor of the National Bank of Ethiopia

Attachments (2)
Memorandum on Economic and Financial Policies for the Period October 2001–September 2002
Technical Memorandum of Understanding

ETHIOPIA

Memorandum on Economic and Financial Policies for the Period

October 2001–September 2002

December 31, 2001[1]

1. Following the end of the border conflict with Eritrea in 2000, the government of Ethiopia started to implement an ambitious adjustment and reform program, with a view to achieving sustainable economic growth, poverty reduction, and medium-term financial viability. The program is being supported by the IMF under a three-year Poverty Reduction and Growth Facility (PRGF) arrangement approved on March 22, 2001. This memorandum reviews performance under the first annual program (October 2000-September 2001) and outlines the government's objectives and policies for the second annual program (October 2001-September 2002), in line with the memorandum on economic and financial policies for 2000/01-2002/03, dated January 29, 2001, and the letter of intent, dated May 29, 2001.

I. Performance Under the First Annual Program

2. Considerable progress was made toward restoring peace between Ethiopia and Eritrea. On December 12, 2000, Ethiopia and Eritrea signed a peace agreement, and to date, Ethiopia has demobilized close to 100,000 soldiers, about 28 percent of the armed forces. On April 18, 2001, a 25-kilometer Temporary Security Zone was established between the two countries.

3. The first annual program under the PRGF arrangement was satisfactorily implemented, notwithstanding delays in the disbursement of external financial assistance and continued deterioration of the terms of trade. Real GDP growth in 2000/01 (fiscal year ending July 7) is estimated to have risen from 5.4 percent in 1999/2000 to 7.9 percent, slightly higher than program projection, as agricultural output rose by 13.2 percent. Inflation turned negative in 2000/01, reflecting a bumper cereal crop and large inflows of food aid; the negative inflation trend continued through September 2001. The external current account deficit (including official transfers) fell to 4.2 percent of GDP in 2000/01 from 5.2 percent in 1999/2000. Coffee exports (which accounted for 40 percent of merchandise exports in 2000/0l) were lower than expected, as both volume and prices fell in 2000/01 and the first quarter of 2001/02. With a slower-than-anticipated pace of project implementation, imports were also lower than expected.

4. Most quantitative performance criteria and benchmarks through October 2001 were observed (Table 1). However, the benchmarks on the floor on net foreign assets (NFA) and

[1] Revised according to the letter addressed to the Managing Director on February 27, 2002.

the ceiling on the net domestic assets (NDA) of the National Bank of Ethiopia (NBE) for July 7, 2001 were not met. These benchmarks were calculated on the assumption that a US$150 million balance of payments International Development Association (IDA) credit would be disbursed before end-June 2001. In the event, the external assistance was disbursed a few days later, and calculations indicate that the NFA floor and the NDA ceiling would have been observed with large margins if these funds had been disbursed as originally anticipated. The adjusted performance criteria for end-September 2001, relating to the NFA of the NBE and the net domestic financing of the general government, adjusted for the excess in disbursed nonproject external financial assistance, were observed. The adjusted performance criterion on the NDA of the NBE was missed.

5. All structural performance criteria and benchmarks through October 2001 were observed (Table 3), with the exception of the introduction of the interbank foreign exchange market (benchmark) set for October 1, 2001, the implementation of which was delayed until October 24 because provision of technical assistance was deferred as a result of the travel suspension related to the September 11, 2001 events.

6. In the fiscal area, the overall budget deficit (including grants and emergency programs) narrowed from 11.4 percent of GDP in 1999/2000 to 5.6 percent in 2000/01, much lower than the program target of 8.4 percent of GDP. Although overall fiscal performance was good, the government had to deal with a tight treasury situation, resulting from a small revenue shortfall and uncertainty on the disbursements of program aid, and difficulties in accelerating capital spending. The implementation of the emergency programs, projected at 1.9 percent of GDP in 2000/01, was slower than expected because of delays in disbursement of external assistance. During the first quarter of 2001/02, fiscal performance was better than programmed, with revenue exceeding projections and higher capital spending offset by lower current outlays.

7. On the revenue side, the government has embarked on comprehensive tax policy reforms and an overhaul of tax administration. In December 2000, the rate of the sales tax was increased from 12 percent to 15 percent and the 10 percent import duty surcharge was removed. In February 2001, new legislation on presumptive taxation and a 5 percent withholding tax on imports became effective. In March 2001, legislation was approved to introduce a taxpayer identification number (TIN) to reinforce the collection power of revenue agencies, and a tax reform implementation task force was established. In July 2001, a large-taxpayer unit was made operational, and in October 2001, draft value-added tax (VAT) legislation was submitted to parliament. Despite these efforts, total revenues in 2000/01 were 6 percent lower than programmed on account of lower domestic sales and excise tax receipts.

8. On the spending side, the government followed a cautious expenditure management policy because of uncertainty regarding the disbursement of program aid, and it slowed domestic defense expenditures, which amounted to 6.2 percent of GDP (lower than the programmed 7.3 percent of GDP). Poverty-targeted outlays (health, education, agriculture, and roads) reached 10.9 percent of GDP. The pace of capital spending was slower than expected. Total expenditure in 2000/01 was 17 percent lower than programmed.

9. In the monetary and exchange areas, the government has started sterilizing excess liquidity, and has taken steps to adopt indirect monetary management instruments and move toward market determination of interest and exchange rates. Reflecting lower-than-projected nonagricultural economic activity and inflation, broad money growth slowed from 14 percent in 1999/2000 to 9.5 percent in 2000/01 (compared with 12.5 percent under the program), and credit to the economy increased by 7.6 percent (compared with 18.4 percent in the program). Net central bank credit to the government declined by about 30 percent in 2000/01, much more rapidly than envisaged under the program, and the government relied more on borrowing from commercial banks. During the first quarter of 2001/02, broad money rose by 3.6 percent, lower than programmed.

10. In order to enhance the use of indirect monetary management and to reduce excess liquidity, the NBE introduced a two-year government bond in November 2000, and increased sales of government securities. As a result, commercial banks' excess reserves fell from 29.6 percent of deposits at end-September 2000 to 5.3 percent at end-July 2001, before rising to 9.7 percent at end-September 2001. To facilitate liquidity management, the NBE introduced a rediscount facility for eligible government papers in March 2001.

11. In the area of financial sector reforms, several measures were taken to improve the competitiveness of the financial sector and strengthen the Commercial Bank of Ethiopia (CBE), in line with recommendations made by IMF-World Bank technical assistance. Government guarantees for bank assets frozen in Eritrea were issued, and the CBE's board was reconstituted to increase private sector participation. Restrictions on the payment of interest on current account deposits were also lifted. However, delays occurred in finalizing a comprehensive study of the NBE's operational, organizational, and administrative setup. A management contract between CBE and a foreign bank was signed on June 29, 2001, and was expected to enter into effect after the Boards of the two institutions had resolved the only remaining issue relating to liabilities of the management and arbitration. In the absence of an agreement on this issue, the foreign bank withdrew from the contract in January 2002.

12. Trade restrictions and administrative controls on access to foreign exchange were lifted in December 2000, and the foreign exchange market started to operate more efficiently. At end-March 2001, the NBE issued directives that lifted the previously existing restrictions on the purchase of foreign exchange for holiday travel and education purposes. On October 24, 2001, the NBE discontinued its weekly wholesale foreign exchange auction and moved its foreign exchange operations to the interbank market. Over the program period, this auction has not lead to a spread of more than 2 percent between buying rates. The value of the birr against the dollar fell by about 2.9 percent in 2000/01, and by another 0.7 percent in the first quarter of 2001/02. At end-September 2001, net foreign assets of the NBE amounted to US$281 million (about 1.7 month of import cover) compared to the programmed US$313 million.

13. In other structural areas, progress was made, with World Bank assistance, in implementing reforms focused on public sector management, including civil service reform and public expenditure policy, and on private sector development. During 2000/01, the

government also pursued its privatization program with the sale of seven public entities, for a total value of US$2.2 million, putting three entities under private management contract, and completing the preparation for privatization of 36 public entities.

II. Program for October 2001-September 2002

A. Medium-Term Strategy and Objectives of the Second Annual Program

14. Building on the progress made under the first annual program, the government is determined to continue implementing steadfastly its medium-term economic reform strategy, as outlined in the interim poverty reduction strategy paper and the January 29, 2001 policy memorandum. The strategy seeks to promote rapid, broad-based and equitable growth by emphasizing rural development and improvement in physical and human capital, and by addressing post-conflict reconstruction and reintegration needs. The key elements of the medium-term strategy continue to be (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 revised medium-term objectives for the next three years, taking into account recent developments, are (a) to achieve an annual real GDP growth of 6 percent, lower than the 6.5-7 percent projected in the original program; (b) to maintain inflation at a low rate of around 3 percent; and (c) to reduce the external current account to 4.6 percent of GDP by 2003/04, after a rise to 7.1 percent in 2001/02.

15. Within this medium-term framework, the second annual program, straddling the two fiscal years 2001/02 and 2002/03, was formulated in the context of the difficult world economic environment characterized by continued deterioration of the terms of trade for Ethiopia, which is further adversely affected by the impact of the events of September 11, 2001. Export prices of coffee, Ethiopia's main export, are projected to fall further by 15 percent in 2001/02, before increasing moderately in 2002/03 and over the medium term. The slowdown of the world economy is also likely to result in lower worker remittances and private capital inflows, as well as lower demand for Ethiopian exports. The activities of Ethiopian Airlines have also been affected. In the face of these difficulties, the government is determined to pursue a restrained fiscal stance and a cautious monetary policy. Nonetheless, the macroeconomic objectives presented in the letter of intent of May 29, 2001, had to be revised. Although the authorities still expect real GDP growth of 6.5–7 percent in 2001/02, the program assumes that the rate would fall to 5.8 percent in 2001/02 and recover somewhat to 6 percent in 2002/03. These growth rates will still hinge on increasing government investment from 8.7 percent of GDP in 2000/01 to 11.2 percent in 2001/02 and 10.7 percent in 2002/03, and improving the environment for private investment through major capacity building and infrastructure expansion, the privatization of a large number of public enterprises, and further progress in financial sector reform. The second annual program also aims at limiting inflation to 3 percent in 2001/02 and in 2002/03, and containing the external current account deficit at 7.1 percent of GDP in 2001/02, and at 6.2 percent in 2002/03, while raising gross reserves from the equivalent of 2 months of following-year imports of goods

and nonfactor services in 1999/2000 to about 2.9 months in 2001/02 and 3.8 months in 2002/03, lower than projected in the original program.

B. Macroeconomic Policies[2]

Fiscal policy

16. The overall fiscal deficit after grants is targeted at 9.1 percent of GDP (including special program expenditure equivalent to 2.2 percent of GDP) in 2001/02, and 7.8 percent of GDP (including special program expenditure equivalent to 1.9 percent of GDP) in 2002/03. The widening of the fiscal deficit by about 3.5 percentage points of GDP in 2001/02, reflects the accelerated implementation of special programs and capital expenditure, and additional poverty-targeted and capital outlays fully financed by concessional external assistance and enhanced Initiative for Heavily Indebted Poor Countries (HIPC Initiative) interim assistance that were not included in the budget adopted in July 2001.[3] Consistent with the budget, the targeted fiscal deficit set in May 2001 in the context of the first review under the PRGF arrangement was Br 4,934 million (8.2 percent of GDP), assuming special program spending of 2.9 percent of GDP and HIPC assistance of 0.7 percent. To reflect these developments, the availability of new concessional external assistance and the need for budgetary appropriation to use the HIPC resources (Br 334 million), a revised supplementary budget[4] will be adopted by the government and submitted to parliament limiting additional fully financed non-HIPC spending to Br 567 million (1 percent of GDP), largely for social and capital outlays. With lower than initially projected spending on special programs and projected delivery of HIPC assistance, the overall deficit in 2001/02 will be limited to Br 5,244 million (9.1 percent of GDP). Based on this, the government's domestic public debt to the banking system would decline by 0.7 percent of GDP in 2001/02 and 0.8 percent in 2002/03.

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[2] In the projections presented in this policy memorandum, nominal GDP for 2001/02, which was projected in May 2001 at Br 59,109 million, was revised downward to Br 57,496 million.

[3] Ethiopia received a loan from the African Development Bank (AfDB) equivalent to US$75 million, with the first tranche of US$50 million to be disbursed in fiscal year 2001/02. The amount of HIPC Initiative assistance is estimated at Br 456 million in 2001/02, of which Br 334 million is expected to be available before the end of the fiscal year. Those amounts were not included in the budget. The 2001/02 budget also assumed disbursement of US$100 million from a new IDA credit, which is now expected in early 2002/03.

[4] The government adopted a preliminary supplementary budget providing for a much higher level of additional spending and double the increase in wages proposed in this memorandum. The revised supplementary budget was adopted and presented to parliament at end-November 2001, and fully reflects the commitments presented in this memorandum.

17. The government is determined to pursue its efforts to lay the foundation for strong revenue performance over the medium term. To achieve the revenue target of 14.7 percent of GDP in 2001/02 and 14.9 percent of GDP in 2002/03, revenue performance will benefit from the full-year impact of the measures implemented since early 2001, improved tax administration (especially the recent establishment of the large-taxpayer unit), and the planned introduction of the VAT by January 2003. Vigorous efforts will also need to be made to improve tax collection (including of arrears), and to combat fiscal fraud. A new Ministry of Revenues was established, and its functions and responsibilities and those of the Ministry of Finance and Economic Development have been delineated. In the period ahead, the government will accelerate the pace of the tax reform program. In particular, it will (a) further strengthen the large-taxpayer office through adequate staffing and training, particularly for its revenue collection, accounting, and audit functions (for this a new salary scale for tax officials will be adopted in December 2001); (b) submit to parliament by June 2002, a revised income tax law, which includes enhanced enforcement procedures and improved penalty regime, with a view to increasing the efficiency of income tax collection, and ensuring the recovery of income tax arrears; (c) implement the tax identification number in Addis Ababa and the regions; (d) develop and implement, by end-June 2002, the systems and programs required to administer the withholding tax on the hard-to-tax group of taxpayers; and (e) develop and implement an audit program to cover all taxes, including customs taxes. With respect to the preparations for the introduction of the VAT, the government will (a) complete the design and computerization of the taxpayer registration process by end-June 2002; (b) complete the operational development of taxpayer services activities, return process, and debt and audit activities by end-September 2002; (c) initiate a publicity campaign, and taxpayer education and advisory visits; and (d) start the computerization of revenue accounting by end-October 2002.

18. The government will continue to pursue a prudent expenditure policy, while further reorienting spending from defense to poverty-targeted outlays and capital expenditure. Total outlays (excluding special programs) are programmed to increase by 2 percent of GDP to 31 percent in 2001/02, but are projected to be reduced to 29.5 percent in 2002/03. Defense outlays will be cut by 1 percentage point of GDP to 5.2 percent in 2001/02, and the government intends to reduce them further in 2002/03. Poverty-targeted spending will increase by 4 percent of GDP to 14.9 percent (including 0.6 percent from HIPC Initiative interim assistance) in 2001/02, and would remain at that level (in terms of GDP ratio) in 2002/03 (including 1.5 percent of GDP from interim HIPC Initiative assistance). Expenditure targeted at poverty reduction will continue to focus on improving services delivery that have an impact on human development (health and education), and on increasing the opportunities for and efficiency of income earning activities (especially in agriculture and road infrastructure). The total wage bill will be limited to Br 4.2 billion (7.4 percent of GDP) in 2001/02. At the time of the first review under the PRGF arrangement, the authorities indicated their intention to assess at the time of the second review whether a modest general wage increase would be feasible and financeable within the budgeted envelope. With lower than budgeted military wage bill and slower filling of vacancies, it will be possible to provide a modest wage increase in January 2002 that will be limited to Br 280 million on an annual basis, representing an average wage increase of 7 percent; the impact over the last six months

in 2001/02 will not exceed Br 140 million. No further increases will be provided until a comprehensive civil service reform strategy has been adopted and a review of wage policy carried out in the context of this reform. Capital outlays (excluding special programs) are projected to increase by 29 percent (to 11.3 percent of GDP) in 2001/02, as project implementation and external disbursement are accelerated and HIPC resources become available. A further increase of 6 percent is projected in 2002/03. The government will also ensure that prudent debt-management policies are implemented.

19. The government has adopted a medium-term action plan to improve substantially the planning, control, tracking and reporting of public expenditures, especially poverty-targeted spending, at the federal and regional levels. In particular, the government will (a) consolidate federal and regional budgets for both the past year and the budget year, including all extra-budgetary funds and accounts, starting with fiscal year 2002/03; and (b) reconcile monetary and fiscal accounts, starting with fiscal year 2001/02. Other actions include (a) enhancing the financial management system through the introduction of a budget classification system in accordance with international standards; (b) reviewing intergovernmental relationships at federal, regional, and *woreda* levels, including transfer mechanisms; (c) strengthening the budgetary preparation process through adherence to the financial calendar; (d) reviewing the impact of reporting procedure on the quality of fiscal data, at the federal and regional levels; (e) introducing an integrated computerized financial information management system, starting with pilot projects at the federal level; and (f) continuing to monitor expenditure execution in the priority sectors (including those in poverty-related spending) in annual expenditure reviews. Technical assistance is expected to be provided by donors to carry out most of these actions.

Monetary policy and financial sector reform

20. Monetary policy will remain geared toward containing inflation and achieving the international reserve targets. The monetary program assumes stable velocity with broad money growing by 11.1 percent in 2001/02 and 9.9 percent in 2002/03. The net domestic assets of the central bank will remain the key aggregate in steering monetary policy. The central bank will continue to closely monitor developments in reserve money and broad money. Progress in fiscal consolidation and the planned reduction in net claims on government, supported by disbursements of foreign aid, is expected to facilitate the continued rebuilding of international reserves while providing room for an adequate increase in credit to the nongovernmental sector, so as to contribute to private-sector-led growth.

21. The NBE will continue sterilizing the excess liquidity of commercial banks by selling treasury bills in the biweekly auctions. In judging the liquidity position of banks, the NBE will continue to take into account treasury bill yield and exchange market developments. The NBE will also encourage the use of the rediscount window by keeping the size of the rediscount penalty (now, the savings rate plus 1–3 percent) under review, so as not to dissuade banks from using this facility. The central bank will also prepare for the introduction of transactions in repurchases (repos), in consultation with banks. The NBE's position in the exchange market will be guided by the program's net foreign assets targets.

The recent replacement of the foreign exchange auction by the foreign interbank exchange market is expected to achieve efficiency gains through broader-based foreign exchange operations.

22. On the basis of the study undertaken with joint technical assistance from the IMF and the World Bank, the government has reviewed its medium-term reform strategy for the financial sector, and will implement further reforms to strengthen the financial sector and improve its competitiveness. The objectives are to achieve a sound financial sector structure that would foster economic development and active competition in Ethiopia by offering an attractive range of financial savings instruments throughout the country and providing for an efficient allocation of financial resources to borrowers.

23. In the context of this strategy, the NBE will adopt by end-March 2002 regulations on the provisioning for nonperforming loans and other doubtful assets in line with international standard practices.[5] The government will (a) take steps by end-March 2002 to strengthen the NBE, following the completion of the ongoing comprehensive study of the NBE, including as necessary, revision of the existing Banking Act to increase the autonomy of the NBE; (b) allow by end-December 2001 a bankers' association to be established formally; (c) ensure that the Construction and Business Bank is brought to the point of sale by end-March 2002, after its balance sheet has been restructured based on the NBE's recommendations; (d) start to implement a restructuring plan to address the weak financial condition of the Development Bank of Ethiopia, taking into account the NBE's supervision findings; (e) encourage public entities to do business with all banks by issuing before end-December 2001 a letter to these entities indicating that they are free to do business with the banks of their choice; and (f) allow private banks to enter into management contracts with foreign institutions. A workshop will be held with IMF and World Bank staffs to discuss the possible role of foreign banks in the Ethiopian economy.

24. With regard to the CBE, which still dominates the financial market with over 80 percent of bank deposits and about 60 percent of bank loans, as noted earlier, the management contract for the CBE with a foreign bank that was signed on June 29, 2001, did not enter into effect as the foreign bank withdrew from the contract in January 2002. At the same time, 28 past and 13 current managers from CBE, including the president and two vice-presidents, were arrested for corruption charges, which are under investigation. The CBE's financial situation also deteriorated in 2001, with non-performing loans increasing significantly. Against this background, a new management team for CBE will be appointed by February 28, 2002, with whom the government will sign a performance contract by end-June 2002, to ensure that CBE is operated effectively on a commercial basis so as to achieve the necessary improvements in financial performance. As had been contemplated in the management contract with the foreign bank, the performance contract will ensure that the

[5] Taking into account Basel Committee guidelines for the restructuring of troubled debt and credit risk.

new management has decision-making autonomy, including on staffing, meeting performance targets, and pursuing delinquent borrowers, as well as on taking steps to strengthen CBE's cost competitiveness and profit and loss situation. To assist the new management, CBE will be concluding a twinning arrangement with—or hire consultants from—reputable international financial institutions by end-September 2002. In the meantime, to improve its financial situation, CBE will fully implement the new provisioning directive to be adopted by end-March 2002. The reserve requirement will be strictly enforced and there will be no lending from the Central Bank to CBE. CBE will also reduce non-performing loans by Birr 0.8 billion by end-September 2002, including through write-offs. CBE will prepare a financial restructuring plan by end-December 2002. CBE will by end-June 2002 also transfer lending authority from the Board to management and create an audit committee of the Board to oversee financial performance of CBE, particularly measures to reduce nonperforming loans. Finally, CBE will prepare quarterly quantitative and qualitative monitoring reports for its Board, indicating progress in meeting the goals of the performance contract.

25. The government is reviewing its strategy for the development of rural financing, including allowing banks to finance microfinance institutions. The NBE will strengthen the regulatory framework and supervision capacity for microfinance institutions.

C. External Sector and Financing Requirements

26. As noted earlier, the external current account deficit is projected to increase to 7.1 percent of GDP in 2001/02, up from 4.2 percent in 2000/01, mainly as a result of the drop in the terms of trade and the impact of the September 11, 2001 events, but it is projected to decline to 6.2 percent in 2002/03. The value of merchandise exports is projected to decrease by 9 percent in 2001/02, reflecting a fall in export prices and virtually stagnant volume. The value of merchandise imports is projected to increase moderately (by 2.6 percent) as a rise of 5.3 percent in volume in 2001/02 will be partly offset by lower prices. Worker remittances, nonfactor export services and net foreign direct investments are also expected to fall as a result of recent events. Some modest improvements are, however, projected in 2002/03.

27. It is expected that much of the demobilization, reconstruction, and sector development efforts will continue to be funded by multilateral and bilateral donors, leading to further improvement of the capital account in 2001/02. The balance of payments is also to benefit from the recent Paris Club rescheduling agreement and the approval of the enhanced HIPC Initiative decision point on November 8, 2001. Balance of payments projections are subject to substantial uncertainty because of Ethiopia's vulnerability to terms of trade shocks, particularly as regards coffee and oil prices, and drought. In view of recent development of world prices, the government will consult with Fund staff if balance of payments developments endanger the achievement of the program objectives.

28. The financing requirements for 2001/02, after the already secured bilateral debt relief and assistance, estimated at US$312 million (4.7 percent of GDP), will be covered by World Bank's balance of payments support lending (US$174 million), the AfDB (US$50 million),

the European Union (US$49 million), and by interim assistance under the enhanced HIPC Initiative (US$39 million). The financing requirement for 2002/03 is estimated at US$267 million (equivalent to 3.7 percent of GDP) and is expected to also be fully covered from the same sources.

29. The government will rely on prudent macroeconomic policies and a market-determined flexible exchange rate to maintain the current account in line with the prospective availability of foreign grants, concessional loans, and debt relief. With regard to new borrowing, the government will neither contract nor guarantee any new external loans on nonconcessional terms. There will be no accumulation of arrears (excluding debt subject to rescheduling or a stock-of-debt operation).

30. The government will finalize bilateral agreements following the Paris Club meeting on April 5, 2001, and will complete the reconciliation of debt data with all bilateral and multilateral creditors by end-December 2001. It will request treatment of debt service to non-Paris Club creditors on at least comparable terms. The government will also strive to improve the debt-monitoring system and debt statistics by formulating and starting the implementation of a comprehensive debt-management strategy by March 2002, with the support of external technical assistance.

31. The government has decided to reduce, by January 2003, the average (nonweighted) import tariff from an existing level of 19½ percent to 17½ percent, lower the maximum tariff rate of 40 percent, and reduce the number of bands from 7 at present. A study of effective protection will be carried out by March 2002 to ensure that the new tariff structure is efficient for the Ethiopian economy.

32. During the program period, the government will not introduce or intensify any existing exchange restrictions, introduce or modify any multiple currency practices, conclude any bilateral payments agreements that are inconsistent with Article VIII of the Fund's Articles of Agreement, or introduce or intensify import restrictions for balance of payments purposes. 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 on October 24, 2001. The authorities will ensure that a spread of more than 2 percent will not arise between the NBE's buying and selling rates and those of the commercial banks. The authorities will lift any remaining restrictions as recommended by the review by the IMF's Legal Department, with a view to accepting the obligations of Article VIII, Sections 2, 3, and 4 of the IMF's Articles of Agreement.

33. The government will continue implementing the recommendations of the recent safeguards assessment review of the NBE conducted by the IMF. In particular, by end-March 2002, the government will (a) 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; and (b) resolve all differences older than six months on the foreign correspondent bank account reconciliations and establish steps to ensure that NBE's accounting records properly reflect the balances held with foreign correspondents. The authorities will also take

advantage of the standing authorization payments process offered by the IMF to ensure timely payments. By end-December 2002, and with technical assistance from the IMF, the authorities will (a) adopt an action plan for the implementation of external and internal audit recommendations; (b) adopt international accounting standards for the preparation of the NBE's financial statements; (c) ensure the finalization of audited financial statements and their publication with full explanatory notes; and (d) strengthen the independence of the internal audit department of the NBE.

D. Social Policies and Poverty Reduction Strategy Paper (PRSP)

34. The government intends to complete the preparation of a full PRSP by the first half of 2002, and will strive to produce a high-quality, fully participatory PRSP that prioritizes and costs initiatives, includes an analysis of the sources of growth and its links to poverty, and elaborates a full-fledged HIV/AIDS strategy. The PRSP will articulate clear medium-term strategies in areas central to poverty reduction, including health, education, road, and agriculture. It will include a social impact analysis of key reforms. The full PRSP will also outline an action plan for further improvement in the quality of the PRSP in the medium term. To date, an interministerial steering committee and a technical committee have been constituted, and an action plan for the preparation of the PRSP has been shared with donors. Wide-ranging consultations at the district, regional, and federal levels started in October 2001, and include civil society, representatives of nongovernmental organizations, the private sector, and the donor community. A report on household income and expenditure and welfare surveys, which addresses the social dimensions and changes in, and characteristics of, poverty, will be released in December 2001.

E. Other Structural and Governance-Related Reforms

35. Besides the structural reforms in the financial, fiscal, and external areas, the government will continue to implement, with the assistance of the World Bank, wide-ranging structural reforms that are conducive to growth and poverty reduction. Measures outlined for the period covered by the second annual program include (a) civil service reform, with the planned adoption of the civil service proclamation, the submission of a code of conduct to parliament, and the implementation of a medium-term wage policy; (b) capacity building, particularly in the Ministry of Revenues and the Ministry of Finance and Economic Development, in the judicial system, at the regional and district levels, and through the establishment of industrial training institutions and private sector associations; (c) agricultural reform, particularly the adoption and implementation of an action plan to improve the efficiency of the agricultural input market, the review, in cooperation with the regions, of the rural land proclamation to ensure an efficient lease policy, and an ambitious training program for farmers; (d) legal and regulatory reforms, including the adoption of a revised competition law, and a review of the implementation of the urban land lease policy to ensure efficient land allocation; (e) the restructuring of the telecommunications and electric utilities, including through private participation and the introduction of regulatory frameworks; and (f) the continuation of the privatization program of parastatals, with 40 enterprises to be brought to the point of sale in 2001/02-2002/03.

36. The government will also during the program period (a) review, and reform if necessary, the institutional and legal framework for public expenditure control, and internal and external audit; (b) make the Auditor General independent and accountable to the parliament; (c) review procurement procedures; and (d) present audited closed government accounts to the parliament for 1998/99, 1999/2000, and 2000/01.

F. Statistics Issues

37. The government will intensify its efforts to improve the timeliness, quality, and coverage of statistics. With technical assistance from the IMF, it will reconcile the monetary and fiscal accounts by September 2002, and improve the compilation methodology for fiscal data, the balance of payments, and national accounts. With regard to the latter, the national accounts unit of the Ministry of Finance and Economic Development will be strengthened through enhancement of staffing, training, and computer resources. With technical assistance from the World Bank, the authorities will strengthen their welfare-monitoring system, with a view to producing high-quality poverty and social indicators on a timely and regular basis, so as to monitor the output and outcomes of the poverty reduction strategy.

G. Monitoring of the Program

38. Program implementation will be monitored with reference to (a) quantitative quarterly performance criteria and benchmarks, which are set out in Table 2 and described fully in the attached technical memorandum of understanding; and (b) structural performance criteria and benchmarks, as specified in Table 3. In view of the uncertainties about delivery of external debt relief and external financial assistance, the program contains contingency mechanisms for the adjustment of the quantitative performance criteria and benchmarks; the modalities of these mechanisms are outlined in the attached technical memorandum of understanding. To ensure adequate monitoring of the program a technical committee has been established and will meet regularly and report monthly to the Minister of Finance and Economic Development on the progress made in the implementation of the program. The IMF's Resident Representative will attend the meetings of this committee.

39. As noted in the cover letter of intent addressed to the Managing Director, the third review under the PRGF arrangement is expected to be completed by end-July 2002. Disbursement of the fourth loan under the PRGF arrangement will be subject to observance of end-March 2002 performance criteria and the completion of the third review. At the time of the third review, performance criteria for end-September 2002 will be established in light of an updated budgetary policy framework for 2002/03. In addition, in the context of the third review, progress in policy implementation in the financial sector area, and for the preparation of the VAT, will be assessed. The fourth review, which is expected to be completed by end-January 2003, will assess progress in policy implementation, in particular in the areas of public expenditure management, tax and financial sector reforms, as well as performance with respect to the end-September 2002 performance criteria. In addition, at that time, performance criteria and benchmarks for the third annual program will be established.

Table 1. Ethiopia: Quantitative Benchmarks and Performance Criteria for the First Annual Program Supported by the PRGF Arrangement, October 2000-September 2001 1/

(In millions of birr, unless otherwise indicated)

	2000					2001								
	July 7	September	December			March			July 7			September 2/		
	Actual (Stock)	Actual	Benchmark	Benchmark Adj.	Actual	Perf. Crit.	Perf. Crit. Adj.	Actual	Benchmark	Benchmark Adj.	Actual	Perf. Crit.	Perf. Crit. Adj.	Actual
I. Quantitative benchmarks and performance criteria														
Floor on net foreign assets of the National Bank of Ethiopia 3/ 4/	1,929	-293	-800	-854	-344	-508	-675	-433	454	285	-309	43	570	704
Ceiling on net domestic assets of the National Bank of Ethiopia 5/ 6/	9,901	1,461	-991	-937	-2,191	-1,741	-1,574	-2,175	-2,948	-2,779	-2,541	250	-277	24
Ceiling on net domestic financing of the general government (incl. privatiz. receipts) 6/ 7/ 8/	17,261	-385	829	883	-34	1,242	1,410	489	746	915	886	450	-77	-549
Ceiling on outstanding external payments arrears (in million of US$) 9/	21	0	0	0	9	-21	-21	0	0	0	0	0	0	0
Ceiling on new nonconcessional external debt contracted or guaranteed by the public sector 10/	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 3/ 4/	520	-176	-497	-497	-202	-165	-332	-256	1,133	964	544	43	570	710
III. Triggers for adjustment of quantitative benchmark and performance criteria														
Disbursed nonproject external funding (in million of U.S. dollars) 11/	0	10	21	....	10	179	....	63	385	....	155	98	...	160

Source: Ethiopian authorities.

1/ Cumulative from July 8, 2000. Program exchange rate is 8.255 Birr/USD.

2/ Established as performance criterion in the context of the first review. Cumulative from July 8, 2001.

3/ Adjusted upward for external assistance (nonproject) that exceeds programmed amounts (paragraph 12 of the Technical Memorandum (TM) dated January 30, 2001).

4/ Adjusted downward for 50 percent of any shortfall in programmed external assistance (nonproject) up to a maximum of US$20 million (paragraph 15 of the TM dated January 30, 2001).

5/ Adjusted downward for external assistance (nonproject) that exceeds programmed amounts (paragraph 13 of the TM dated January 30, 2001).

6/ Adjusted upward for 50 percent of any shortfall in programmed external assistance (nonproject) up to a maximum of US$20 million (paragraph 15 of the TM dated January 30, 2001).

7/ Adjusted downward for external assistance (nonproject) that exceeds programmed amounts (paragraph 14 of the TM dated January 30, 2001).

8/ Stock at July 7, 2000 reflects domestic government borrowing, but excludes privatization receipts.

9/ Continuous performance criterion on the nonaccumulation of new external arrears.

10/ 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 been received. Excluded from this limit are short-term import credits and long-term financing operations of Ethiopian Airlines.

11/ Including World Bank fertilizer projects.

Table 2. Ethiopia: Quantitative Benchmarks and Performance Criteria for the Second Annual Program Supported by the PRGF Arrangement, October 2001-September 2002 1/

(In millions of birr, unless otherwise indicated)

	2001				2002			
	July 7	September	December 3/		March		July 7	September
	Actual	Actual	Benchmark	Revised	Indicative	Perf. Crit.	Benchmark	Indicative
	(Stock)	2/		benchmark	Target	4/		Target 5/
I. Quantitative benchmarks and performance criteria								
Floor on net foreign assets of the National Bank of Ethiopia 6/ 7/	1,672	704	253	427	317	734	1,159	1,230
Ceiling on net domestic assets of the National Bank of Ethiopia 8/ 9/	7,361	24	-90	-158	-190	-225	-334	-371
Ceiling on net domestic financing of the general government (incl. privatiz. receipts) 9/ 10/ 11/	17,313	-549	400	-280	500	0	400	-371
Ceiling on outstanding external payments arrears (in million of US$) 12/	0	0	0	0	0	0	0	0
Ceiling on new nonconcessional external debt contracted or guaranteed by the public sector 13/	0	0	0	0	0	0	0	0
II. Indicative target								
Floor on net foreign liquid reserves of the National Bank of Ethiopia 6/ 7/	1,193	710	253	433	317	740	1,159	1,230
III. Triggers for adjustment of quantitative benchmark and performance criteria								
Disbursed nonproject external funding (in million of U.S. dollars) 14/	0	150	179	179	247	329	423	168

Source: Ethiopian authorities.

1/ Cumulative from July 8, 2001. Program exchange rate is 8.524 Birr/USD.

2/ The September 2001 calculations are based on the previous program exchange rate of 8.255 Birr/USD.

3/ Performance under the end-December 2001 benchmarks will be assesed at the time of the third review.

4/ Established as performance criterion in the context of the second review.

5/ Cumulative from July 8, 2002. To be established as performance criteria in the context of the third review.

6/ 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).

7/ 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 (Paragraph 15 of the TM dated December, 2001).

8/ Adjusted downward for external assistance (nonproject, excluding enhanced HIPC interim assistance) that exceeds programmed amounts (Paragraph 13 of the TM dated December, 2001).

9/ 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 (Paragraph 15 of the TM dated December, 2001).

10/ Adjusted downward for external assistance (nonproject, excluding enhanced HIPC interim assistance) that exceeds programmed amounts (Paragraph 14 of the TM dated December, 2001).

11/ Stock at July 7, 2001 reflects domestic government borrowing, but excludes privatization receipts.

12/ There shall be a continuous performance criterion on the nonaccumulation of new external arrears.

13/ 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 been received. Excluded from this limit are short-term import credits and long-term financing operations of Ethiopian Airlines.

14/ Excluding fertilizer projects.

Table 3. Ethiopia: Structural Benchmarks and Performance Criteria Under the First and Second Annual Programs Supported by the PRGF Arrangement (Revised)

Structural Benchmarks and Performance Criteria	Timing
First Annual Program:	
Establish a tax reform implementation task force.	April 31, 2001 (done) (benchmark)
Sign a management contract for the CBE with a reputable international firm that provides experienced and qualified management staff.	June 30, 2001 (done) (performance criterion)
Establish a fully operational large-taxpayer unit.	July 1, 2001 (done) (performance criterion)
Submit draft value-added tax legislation to parliament.	October 1, 2001 (done) (performance criterion)
Terminate the wholesale foreign exchange auction and move foreign exchange operations to the interbank market.	October 1, 2001 1/ (done on October 24) (benchmark)
Second Annual Program:	
Appoint a new management team that will operate CBE on a commercial basis.	February 28, 2002 (prior action)
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 (structural 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 (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 (benchmark)
Reduce non-performing loans by Birr 0.8 billion (from Birr 3.9 billion at end-December 2001), including through write-offs.	September 30, 2002 (benchmark)
Reconcile monetary and fiscal accounts.	September 30, 2002 (structural benchmark)
Consolidate federal and regional budgets for both the past year and the budget year—including all extrabudgetary funds and accounts.	September 30, 2002 (structural benchmark)

1/ Implementation delayed because of delayed provision of technical assistance as a result of travel suspension related to recent events.

ETHIOPIA

Technical Memorandum of Understanding

December 31, 2001

I. INTRODUCTION

1. This memorandum sets out the understandings between the Ethiopian authorities and staff of the International Monetary Fund (IMF) regarding the definitions of quantitative and structural performance criteria and benchmarks, as well as indicative targets, for the second annual program under the three-year arrangement supported by the Poverty Reduction and Growth Facility (PRGF), as well as the mechanisms to monitor the program and related reporting requirements. To monitor the evolution of the economy during the program period, the Ethiopian authorities will provide the data listed in each section below to the African Department of the IMF, in accordance with the indicated timing. The financial criteria will be monitored on the basis of the methodological classification of monetary and financial data that exists as of October 1, 2001. For program purposes, the public sector consists of the general government (comprising the federal and regional governments) and the National Bank of Ethiopia (NBE). The quantitative targets for end-December 2001 and July 7, 2002 are benchmarks, and those at end-March 2002 constitute performance criteria. The indicative benchmarks for end-September 2002 will be established as performance criteria in the context of the third review to be completed by end-July 2002.

II. QUANTITATIVE PERFORMANCE CRITERIA AND BENCHMARKS: DEFINITIONS AND REPORTING STANDARDS

A. Floor for Net Foreign Assets (NFA) of the NBE

2. **Definition.** The NFA of the NBE are defined as the difference between gross international reserves and all foreign liabilities of the NBE, including debts to the IMF and other long- and short-term liabilities to nonresidents of the NBE. Foreign liabilities also include foreign-currency-denominated domestic liabilities of the NBE. For calculating the criteria, foreign assets and liabilities shall be valued at the U.S. exchange rates prevailing at end-September 2001. Gold holdings will be valued at the U.S. dollar market price at end-September 2001. Finally, the net foreign assets shall be converted into local currency at the exchange rate at end-September 2001 (8.524 birr per U.S. dollar).[1] Performance relative to an indicative floor on the net foreign liquid reserves of the NBE will also be monitored.[2]

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[1] The program exchange rate.

[2] This aggregate consists of unencumbered gross reserves and foreign-currency-denominated liabilities of the NBE, excluding donor funds in transit.

3. **Reporting.** Data on gross international reserves and foreign liabilities of the NBE will be transmitted to the African Department of the IMF through the Fund Resident Mission on a weekly basis within ten days of the end of each week. The NBE will also report the breakdown between liquid and unencumbered gross international reserves and those reserve assets that are pledged, swapped, or encumbered.

B. Ceiling on Net Domestic Assets (NDA) of the NBE

4. **Definition.** The NDA of the NBE are defined to include net credit to the government, credit to enterprises and individuals, claims on banks, and other items net, but exclude foreign currency valuation adjustments.

5. **Reporting.** The monthly balance sheets of the NBE will be transmitted within six weeks of the end of each month.

C. Limit on the Net Domestic Financing of the General Government

6. **Definition.** The net domestic financing requirement of the general government is defined as the sum of (i) the change in the stock of general government domestic (bank and nonbank) debt; (ii) domestic and foreign receipts from divestiture operations, net of related expenditures; (iii) any pending overdue bills;[3] and (iv) the floating debt.[4] Net bank claims on general government consist of NBE and commercial bank claims on the government, including treasury bills and other government liabilities, net of general government deposits with the NBE and commercial banks. Nonbank claims comprise treasury bills, bonds, and other general government paper placed with nonbank institutions or with the public.

7. **Reporting.** Data on domestic financing (bank and nonbank) of the general government (including treasury bills and government bonds held by the nonbank public) will be transmitted on a monthly basis, within six weeks of the end of each month, except for the data on regional governments, which will be furnished within eight weeks after the end of each month. Net divestiture receipts, with gross receipts broken down into domestic and foreign currency, will be reported on a monthly basis, within six weeks of the end of each

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[3] Overdue bills are defined as bills pending for payment beyond 30 days after a request for payment authorization has been made (i.e., pending for a period that exceeds the normal commercial grace period). These bills constitute either domestic or external payments arrears (including also arrears on external debt service except for pending payments related to debt subject to debt relief). At end-September 2001, there were no overdue bills reported.

[4] For the purposes of program monitoring, floating debt of the general government is defined as the sum of (i) the stock of accrued expenditures (payment authorization requests) for which payments orders have not been issued; and (ii) the stock of payment orders issued but not encashed.

month. Reporting on domestic and external arrears (i.e., overdue bills) will be monthly, within six weeks of the end of each month.

D. Ceiling on External Payment Arrears

8. **Definition.** External payment arrears are defined as overdue debt service arising in respect of obligations incurred directly or guaranteed by the public sector, except on debt subject to rescheduling or restructuring. The program requires that no new external arrears be accumulated at any time under the arrangement.

9. **Reporting.** The accounting of nonreschedulable external arrears by creditor (if any), with detailed explanations, will be transmitted on a monthly basis within four weeks of the end of each month. This accounting would include, separately, arrears owed by the federal government and other public sector entities; arrears owed by Ethiopian Airlines; and arrears owed to Paris Club creditors, non-Paris Club creditors, and other creditors. Data on other arrears, which are reschedulable, will be provided separately.

E. Ceiling on Nonconcessional External Debt

10. **Definition.** External debt limits apply to the contracting or guaranteeing of nonconcessional external debt by the public sector or any other agencies on behalf of the public sector.[5] External debt includes all current liabilities, which are created under a contractual arrangement through the provision of value in the form of assets (including currency) or services, and which require the obligor to make one or more payments in the form of assets (including currency) or services, at some future point(s) in time to discharge the principal and/or interest liabilities incurred under the contract. This definition includes loans, suppliers' credits, and leases (operational and financial leases). Concessionality will be based on a currency-specific discount rate based on the ten-year average of the OECD's commercial interest reference rates (CIRR) for loans or leases with maturities greater than 15 years and on the six-month average CIRR for loans or leases maturing in less than 15 years. Under this definition of concessionality, only debt with a grant element equivalent to 35 percent or more will be excluded from the debt limits.

11. **Reporting.** A loan-by-loan accounting of all new concessional and nonconcessional loans contracted or guaranteed by the public sector, including detailed information on the amounts, currencies, and terms and conditions, as well as relevant supporting materials, will be transmitted on a quarterly basis within four weeks of the end of each quarter.

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[5] 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 (see Annex) but also to commitments contracted or guaranteed for which value has not been received. Excluded from this limit are short-term import credits and long-term financing operations of Ethiopian Airlines.

III. ADJUSTERS

A. Excess in Disbursed External Financial Assistance

12. In case of an excess external financing beyond the programmed amounts shown in Table 2 annexed to the memorandum on economic and financial policies (MEFP) for the period October 2001-September 2002, the floor on net foreign assets of the NBE will be adjusted **upward** (with two exceptions), by the amount of disbursed external financing **in excess** of the programmed amounts (comprising non-project-related loans and grants, including special programs, but excluding interim debt relief under the enhanced HIPC Initiative) at the end of each quarter (Table 2 annexed to MEFP), valued at the average exchange rate of the quarter. The two exceptions are (i) an amount of up to US$50 million in excess of programmed overall external financing can be spent on special programs in the case that the overall excess funding stems from higher than programmed financing of the special programs; and (ii) an amount of up to US$50 million in excess of programmed overall external financing can be spent on poverty-targeted outlays if the excess stems from higher than programmed other non-project financing. Accordingly, within this limit, the floor on net foreign assets, and the ceilings on net domestic assets of the NBE, and domestic financing of the general government will not be adjusted. The interim debt relief under the enhanced HIPC Initiative will be spent in accordance with the principles in the enhanced HIPC Initiative decision point document (EBS/01/174; paragraphs 61 and 62).

13. The ceiling on net domestic assets of the NBE will be adjusted **downward** (with the two above-mentioned exceptions) by the amount of disbursed external financing **in excess** of the programmed amounts (comprising non-project-related loans and grants, including special programs, but excluding interim debt relief under the enhanced HIPC Initiative) at the end of each quarter (Table 2 annexed to MEFP), converted into birr at the average exchange rate of the quarter.

14. The ceiling on domestic financing of the general government will be adjusted **downward** (with the two above-mentioned exceptions) by the amount of external financing disbursed to the budget **in excess** of the programmed amounts (comprising non-project-related loans and grants, including special programs, but excluding interim debt relief under the enhanced HIPC Initiative) at the end of each quarter (Table 2 annexed to MEFP), converted into birr at the average exchange rate of the quarter.

B. Shortfall in External Financial Assistance

15. In case of a shortfall in external financing below the programmed amounts, (comprising non-project-related loans and grants, including special programs, but excluding interim debt relief under the enhanced HIPC Initiative) shown in Table 2 annexed to the MEFP:

- The floor on the NFA of the NBE will be adjusted **downward** by a maximum of 50 percent of the amount of the shortfall below the programmed amount, but by no more than US$50 million. The adjustment will be converted at the average exchange rate of the quarter.

- The ceiling on the NDA of the NBE will be adjusted **upward** by a maximum of 50 percent of the amount of the shortfall, but by no more than US$50 million. The adjustment will be converted into birr at the average exchange rate of the quarter.

- The ceiling on general government net domestic financing will be adjusted **upward** by a maximum of 50 percent of the amount of shortfall in external financial assistance disbursed to the budget, but by no more than US$50 million. The adjustment will be converted into birr at the average exchange rate of the quarter.

IV. Other Reporting Requirements for Program Monitoring

A. Macroeconomic Monitoring Committee

16. The macroeconomic monitoring committee, composed of senior officials from the Ministry of Finance and Economic Development, the NBE, and other relevant agencies, shall meet regularly and be responsible for monitoring the performance of the program, recommending policy responses, informing the IMF regularly about the progress of the program, and transmitting the supporting materials necessary for the evaluation of performance criteria and benchmarks. The committee shall provide the IMF with a progress report on the program on a monthly basis within four weeks of the end of each month, using the latest available data.

B. Developments on Structural Performance Criteria and Benchmarks

17. The authorities will notify the African Department of the IMF of developments on structural performance criteria and benchmarks as soon as they occur. The authorities will provide the documentation, according to the dates in Table 3 annexed to the MEFP, elaborating on policy implementation.

C. Data Reporting

Production and prices

18. The following data shall be transmitted:

- The monthly disaggregated Addis Ababa consumer price index will be transmitted within four weeks of the end of each month.

- The national consumer price index and its regional components will be transmitted within eight weeks of the end of each month.

- Any revisions to the national accounts data will be transmitted within three weeks of the date of the revision.

Public finance

19. Monthly data on public finance will require a consolidated budget report of the federal and regional governments comprising:

- the revenue data by each major item, including that collected by the Federal Inland Revenue Authority, the Customs Office, and the regional governments;
- details of the recurrent and capital expenditure of the federal and regional governments; and
- details of budget financing, domestic, and external data will be transmitted within six weeks of the end of each month and data of the regional governments within eight weeks of the end of the month.

Monetary sector data

20. The following data will be transmitted on a daily/weekly/biweekly basis within one/five working days of the end of each day/week:

- treasury bill auction details (rates, amounts, and holders); and
- interbank foreign exchange rates and transactions.

21. The balance sheet of the NBE and the consolidated balance sheets of the commercial banks will be transmitted on a monthly basis within six weeks of the end of each month. The stocks of government securities, detailed information on interbank money market transactions (terms, duration, and participating institutions), and interest rate developments will be transmitted on a monthly basis within two weeks of the end of each month.

External sector data

22. The following data will be transmitted as follows:

- The interbank market exchange rate, as the simple average of the daily-weighted average buying and selling rates, will be transmitted on a weekly basis within five business days of the end of the week.
- Exports, imports, and other balance of payments data on services, private transfers, and capital account transactions will be transmitted on a quarterly basis within six weeks of the end of each quarter.
- The Ethiopian authorities will provide IMF staff regularly with detailed monthly data on the volume and prices of imported petroleum products and exports of coffee.

- The Ethiopian authorities will consult with IMF staff if balance of payments developments endanger the achievement of program objectives.

February 27, 2002

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

Dear Mr. Köhler:

Further to our letter dated December 31, 2001, on the second review and the second annual program under the three-year Poverty Reduction and Growth Facility (PRGF) arrangement approved on March 22, 2001, this is to inform you that we could not meet the prior action on the entering into effect of the management contract for the Commercial Bank of Ethiopia with a foreign bank, as the State Bank of India withdrew from the contract.

After discussion with a visiting IMF staff team, we agreed to replace paragraphs 11 and 24 relating to the Commercial Bank of Ethiopia in the memorandum on economic and financial policies attached to our letter dated December 31, 2001, by the following text:

New paragraph 11:
"In the area of financial sector reforms, several measures were taken to improve the competitiveness of the financial sector and strengthen the Commercial Bank of Ethiopia (CBE), in line with recommendations made by IMF-World Bank technical assistance. Government guarantees for bank assets frozen in Eritrea were issued, and the CBE's board was reconstituted to increase private sector participation. Restrictions on the payment of interest on current account deposits were also lifted. However, delays occurred in finalizing a comprehensive study of the NBE's operational, organizational, and administrative setup. A management contract between CBE and a foreign bank was signed on June 29, 2001, and was expected to enter into effect after the Boards of the two institutions had resolved the only remaining issue relating to liabilities of the management and arbitration. In the absence of an agreement on this issue, the foreign bank withdrew from the contract in January 2002."

New paragraph 24:
"With regard to the CBE, which still dominates the financial market with over 80 percent of bank deposits and about 60 percent of bank loans, as noted earlier, the management contract for the CBE with a foreign bank that was signed on June 29, 2001, did not enter into effect as the foreign bank withdrew from the contract in January 2002. At the same time, 28 past and 13 current managers from CBE, including the president and two vice-presidents, were arrested for corruption charges, which are under investigation. The CBE's financial situation also deteriorated in 2001, with non-performing loans increasing significantly. Against this background, a new qualified management team for CBE will be appointed by February 28, 2002, with whom the government will sign a performance contract by end-June 2002, to ensure that CBE is operated effectively on a commercial basis so as to achieve the necessary improvements in financial performance. As had been contemplated in the management contract with the foreign bank, the performance contract will ensure that the new

management has decision-making autonomy, including on staffing, meeting performance targets, and pursuing delinquent borrowers, as well as on taking steps to strengthen CBE's cost competitiveness and profit and loss situation. To assist the new management, CBE will be concluding a twinning arrangement with—or hire consultants from—reputable international financial institutions by end-September 2002. In the meantime, to improve its financial situation, CBE will fully implement the new provisioning directive to be adopted by end-March 2002. The reserve requirement will be strictly enforced and there will be no lending from the Central Bank to CBE. CBE will also reduce non-performing loans by Birr 0.8 billion by end-September 2002, including through write-offs. CBE will prepare a financial restructuring plan by end-December 2002. CBE will by end-June 2002 also transfer lending authority from the Board to management and create an audit committee of the Board to oversee financial performance of CBE, particularly measures to reduce nonperforming loans. Finally, CBE will prepare quarterly quantitative and qualitative monitoring reports for its Board, indicating progress in meeting the goals of the performance contract."

Table 3 on the structural benchmarks and performance criteria attached to the memorandum on economic and financial policies has been revised to reflect the above changes.

Sincerely yours,

/s/

Sufian Ahmed
Minister of Finance and
Economic Development

/s/

Teklewold Atnafu
Governor of the National Bank of Ethiopia

Attachment (1)
Structural Benchmarks and Performance Criteria Under the Second Annual Program Supported by the PRGF Arrangement

Table 3 to MEFP dated December 31, 2001 (Revised)

Ethiopia: Structural Benchmarks and Performance Criteria Under the Second Annual Programs Supported by the PRGF Arrangement

Structural Benchmarks and Performance Criteria	Timing
Appoint a new qualified management team that will operate CBE on a commercial basis.	*February 28, 2002 (prior action)*
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 (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 30, 2002 (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, 2002 (benchmark)*
Reduce non-performing loans by Birr 0.8 billion (from Birr 3.9 billion at end-December 2001), including through write-offs.	*September 30, 2002 (benchmark)*
Reconcile monetary and fiscal accounts.	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)

Ethiopia: Relations with the Fund

(As of October 31, 2001)

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

II. General Resources Account	**SDR Million**	**Percent of quota**
Quota	133.70	100.0
Fund Holdings of Currency	126.59	94.7
Reserve position in Fund	7.12	5.3

III. SDR Department:	**SDR Million**	**Percent of allocation**
Net cumulative allocation	11.16	100.0
Holdings	0.15	1.3

IV. Outstanding Purchases and Loans:	**SDR Million**	**Percent of quota**
Structural Adjustment Facility (SAF)	19.77	14.8
Enhanced Structural Adjustment Facility (ESAF)	64.25	48.1

V. Latest Financial Arrangements:

Type	Approval Date	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
PRGF	03/22/2001	03/21/2004	86.90	34.76
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: (SDR Million; based on existing use of resources and present holdings of SDRs):

	Overdue 10/31/2001	Forthcoming 2001	2002	2003	2004	2005
Principal	0.0	2.1	12.8	10.0	8.7	5.9
Charges/interest	0.0	0.3	0.7	0.6	0.6	0.5
Total	0.0	2.4	13.5	10.6	9.3	6.4

VII. Safeguards Assessment:

Under the Fund's safeguards assessment policy, the National Bank of Ethiopia is subject to a full Stage One safeguards assessment with respect to the Poverty Reduction and Growth Facility arrangement approved on March 21, 2001, which is scheduled to expire on March 20, 2004.

A Stage One safeguards assessment of the National Bank of Ethiopia was completed on May 4, 2001. The assessment concluded that high risks may exist in the financial reporting framework and internal controls system and recommended a Stage Two (on-site) assessment. The Stage Two assessment was completed on September 4, 2001.

VIII. Exchange Rate Arrangement

Effective October 24, 2001, the National Bank of Ethiopia (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 November 30, 2001 was Br 8.5565 = US$1.

In March 2001, the authorities eliminated the 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. This amount may be retained for a period of 28 days, after which it has to be converted into local currency by the customers' 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 exchange restrictions with respect to Article VIII, Sections 2, 3, and 4 of the IMF's Articles of Agreement remain.

IX. Article IV Consultation

Ethiopia is on the standard 12-month cycle. 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.

X. Implementation of HIPC Initiative:

	Enhanced framework
Commitment of HIPC assistance	
Decision point date[1]	11/6/2001
Assistance committed (end-2000/01 NPV terms)[2]	
Total assistance (US$ million)	1,275
Of which: Fund assistance (SDR million)	26.9
Completion point date	Floating
Delivery of Fund assistance (SDR million)	
Amount disbursed	4.0
Interim assistance	4.0
Completion point	...
Amount applied against member's obligations (cumulative)	0.5

XI. Technical Assistance (1999-present)

Department	**Purpose**	**Time of Delivery**
MAE	Bank supervision (resident expert)	August 1998-October 1999
FAD	Tax administration (resident expert)	May 1999-July 2001
STA	Consumer price index	March-April 2000
FAD	Introduction of a 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	Introduction of interbank foreign exchange Market	June-July 2001

[1] Decision was approved in principle by the Fund.

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

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	Multitopics	January 2002

XI. Resident Representative

Mr. Alexander Kyei assumed the post in August 2001.

Ethiopia: Relations with the World Bank Group

(As of end-November 2001)

1. The World Bank's broad-based strategy of support for the government aims at assisting the country in achieving high rates of sustained economic growth and poverty reduction. In the immediate postwar period, the Bank's objective is to help the government deal as quickly as possible with the human, material, and financial impact of the war with Eritrea, while simultaneously reengaging on core development issues. As of October 2001, the Bank had 16 active credits in Ethiopia and 62 loans/credits closed. Of the latter, about 80 percent were IDA credits (including a structural adjustment credit (SAC)). No new projects were presented to the Board for approval after the first quarter of fiscal-year (FY) 1999 and in FY 2000, as the Bank suspended new loans to both combatants in the Eritrea-Ethiopia conflict. However, disbursements from already approved projects continued. After the signing of the Cessation of Hostilities Agreement on June 18, 2000, Bank lending to Ethiopia resumed in July with the approval of the Women's Development Initiatives Project. In September, the Board approved Ethiopia's Multi-Sectoral HIV/AIDS Project. The latter was approved under a Multi-Country HIV/AIDS Program (MAP) for Africa. Ethiopia was one of the first two countries to benefit from this program.

2. In December 2000, the World Bank approved the Interim Support Strategy for Ethiopia. Up to US$700 million would be provided in new credits during the next 18-24 months to address the impact of the conflict. The strategy aims at: (i) addressing the human, infrastructure and economic emergency, and setting the economy back on the path of economic recovery; (ii) tackling weaknesses in the Bank's portfolio; and (iii) initiating long-term assistance in the areas of food security, HIV/AIDS, and capacity building for the delivery of essential services. US$30 million was reallocated from the current portfolio to the emergency program: US$17.5 million from the Ethiopian Social Rehabilitation Development Fund, US$9.8 million from Energy II, and US$2.5 million from the Ethiopian Multi-Sectoral HIV/AIDS Program. Concurrently, two emergency operations —the Emergency Demobilization and Reintegration Project (EDRP), for $170 million, and the Emergency Recovery Program (ERP), for $230 million, were approved by the Bank's Board in December 2000. The two operations became effective in February 2001. Two Learning and Innovation Loans were also approved, one for Medicinal Plants ($2.6 million) in February and one for Global Distance Learning ($5 million) in April, 2001. A supplement to the current National Fertilizer Project of $50 million will be submitted for consideration by the Bank's Board, and a quick-disbursing Economic Rehabilitation Support Credit ($150 million) was approved by the Bank's Board on June 5, 2001.

3. In October 2000, a Country Portfolio Performance Review (CPPR) identified significant weaknesses in portfolio implementation. In response, a Portfolio Improvement Program (PIP) was prepared and agreed with the government. Implementation of the PIP will be monitored by a joint IDA government team. Early signs of improvement are encouraging.

4. The Bank is also providing significant nonlending assistance through a close policy dialogue, and studies including Poverty and Policies for the New Millennium (green cover, October 1999); a Country Economic Memorandum–Transitions in a Poor Economy (buff cover, June 1999); and a Public Expenditure Review (gray cover, August 2000). A further Public Expenditure Review is being finalized. A full Country Assistance Strategy (CAS) will be prepared in FY 2002, as will a report "Ethiopia: the Challenge of International Integration." The World Bank Institute (WBI) has also helped train Ethiopian nationals in the areas of economic journalism, agriculture management, credit risk management, and commercial banking and bank supervision.

5. In FY 1999, the IFC's Board approved an $8.6 million investment in the Sheba Tannery project (producing finished leather goods for export). The Technical Assistance project to set up a stock exchange in Ethiopia has been funded. The IFC has also supported a Plant Hire study, which has been completed and disseminated to interested parties in Ethiopia and elsewhere. However, investment activity has been curtailed by the war. With the return of peaceful conditions and continued reforms to improve the enabling environment, the IFC is prepared to broaden the range of investment and assistance activities beyond technical assistance and capacity building.

6. MIGA and the Foreign Investment Advisory Service (FIAS) are assisting in strengthening the capacity of the Ethiopian Investment Authority to increase inward investment flows. MIGA has been asked to use its good offices to mediate the resolution of claims against the government of Ethiopia as a consequence of the uncompensated expropriations by the Dergue regime. At present, MIGA has no investment guarantees in Ethiopia. MIGA has reextended its insurance coverage to Ethiopia on a case-by-case basis.

Ethiopia: Relations with the World Bank Group
(As of end-November 2001; 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: 61					
P000734	1993	Road Rehabilitation	96.0	22.7	0.0
P000758	1994	Calub Energy Development Project	74.3	54.6	0.0
P000753	1995	National Fertilizer Project	120.0	5.4	0.1
P000752	1995	National Seeds Project	22.0	5.1	4.1
P000771	1996	Ethiopia Social Rehabilitation Fund	120.0	34.4	11.5
P000764	1996	Water Supply Development & Rehabilitation	35.7	11.6	0.0
P000733	1998	Agriculture Research and Training	60.0	42.0	0.0
P000732	1998	Education Sector Investment	100.0	51.4	0.0
P000736	1998	Energy II	200.0	121.9	0.0
P000755	1998	Road Sector Development Program	309.2	204.1	0.0
P000756	1999	Health Sector	100.0	62.3	0.0
P073196	2001	Demobilization and Reintegration Project	170.6	139.9	0.0
P067084	2001	Emergency Recovery and Rehabilitation Project	230.0	187.9	0.0
P069886	2001	Multisectoral HIV/AIDS Project	59.7	49.1	0.0
P050342	2001	Women's Development Initiatives Project	5.0	4.8	0.0
P072890	2001	Economic Rehabilitation Support Credit	150.0	150.0	0.0
Total for 17 active credits			1,852.5	1,147.2	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					
1999	Sheba Tannery	5.0	3.6	0.0	8.6
Total gross commitments 1/		12.3	18.2	1.7	32.1
Less: cancellations, terminations, repayments and sales		7.3	14.6	1.7	23.6
Total commitments now held		5.0	3.6	0.0	8.6

Source: World Bank.

1/ Gross commitments consist of approved and signed projects.

Ethiopia: Statistical Issues

Real sector

1. In the context of the last three-year Enhanced Structural Adjustment Facility (ESAF) arrangement, which called for the adoption of better statistical practices, the authorities improved the timeliness and coverage of national accounts. Preliminary national accounts are available through 2000/01 (July 8-July7), but data on sectoral deflators had not been compiled as of end-November 2001. A new series of GDP estimates using a 1995/96 base is under construction, but the quality of these estimates (which previously used a 1980/81 base) still suffers from a lack of continuity in the conduct of some surveys. The Addis Ababa consumer price index (CPI) is published with a four- to six-week delay, but the national CPI is published with a two- to three-month lag and suffers from methodological problems. STA missions have visited Ethiopia to review CPI statistics and have recommended several changes that are under implementation, including an update of the CPI basket based on 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, i.e., the privatization, road, fuel stabilization, and sugar auction funds), and there are discrepancies between data on 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 four-week lag. A STA technical assistance mission in April 2001 recommended correcting classification problems in international reserves, and in the resident sector data. It also stressed the need for reporting nonperforming assets and broadening the coverage of the monetary survey to include other financial institutions (especially credit and savings cooperatives). Finally, it urged the authorities to ensure consistency between monetary and fiscal data.

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, although 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 ASYCUDA system 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.

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 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 end-November 2001)

	Exchange Rates	Net Foreign Assets of 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	November 15, 2001	September 2001	September 2001	September 2001	September 2001	September 2001	June 2001	September 2001	July 2001	September 2001	2000/01	July 7, 2001
Date received	November 16, 2001	October 2001	October 2001	October 2001	October 2001	October 2001	September 2001	October 2001	October 2001	October 2001	November 2001	September 2001
Frequency of data	Daily	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Quarterly	Monthly	Annual	Biannually
Frequency of reporting	Daily	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	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 and Economic Development	Ministry of Finance and Economic Development	Ministry of Finance and Economic Development
Mode of reporting	Fax	Fax	Fax	Fax	Fax	Fax	Fax	Fax	On mission	Fax	On mission	On mission
Frequency of publication	Daily	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	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.
[2] National CPI only. For Addis Ababa CPI, the latest observation is September 2001 (received November 2001).
[3] Export and import data are based on customs record.
[4] Effective May 20, 1999, the Ethiopian authorities began to report data on net foreign assets of the banking system to the Fund on an end-of-month basis only.

Ethiopia: Summary of Conclusions of Safeguards Assessment

The Stage One safeguards assessment of the National Bank of Ethiopia (NBE), which was based on documentation reviewed at IMF headquarters, identified several indicators of vulnerability in the NBE's overall framework of safeguards and recommended an on-site assessment to follow up on certain critical indicators of vulnerability. The on-site assessment proposed remedies as detailed below. The authorities have accepted the need for the proposed remedies, management has endorsed the recommendations, and the staff will integrate the remedies with the ongoing PRGF arrangement.

The on-site assessment indicated that a **number of safeguards were already in place or had been initiated to mitigate some of the findings of the Stage One report**. The NBE management embarked on a strategic restructuring of the bank's functions and operations during 2001, aimed at bringing the NBE in line with recognized best practices, including a number of proposed improvements that overlap with safeguards assessments. External consultants have assisted the bank in this restructuring program, which is expected to be completed by end-2001, with the execution stage planned for early 2002. An area of important concern raised by the consultants is the urgent need to **restructure the internal audit department**, as also recommended by the Stage One report and by a 1997 MAE technical assistance mission.

The NBE's external auditor, the Audit Services Corporation (ASC), has issued a **qualified audit opinion** for several years. The audit qualifications have arisen from the inclusion in the financial statements of several items that show an opaque financial position. The nature of these items are indicative of **problems with the NBE's accounting records in general**, and the recurring audit qualifications are potentially damaging to the NBE's reputation and credibility. The staff recommended that these items be resolved so that the ASC could issue an unqualified audit opinion by end-2001 on the NBE financial statements for the year ended June 30, 2001 (set as a structural benchmark for March 2002).

The ASC has for several years reported **unresolved differences between the accounting records and third-party confirmations** received from foreign correspondent banks. In addition, the on-site assessment noted several foreign correspondent account balances with long-unresolved issues. The staff recommended, therefore, that the NBE resolve all reconciliation differences older than six months on the foreign correspondent accounts and establish steps to ensure that the accounting records properly reflect the balances held with foreign correspondents. **The NBE also plans to strengthen its safeguards over net foreign asset reported to the IMF** by formalizing a reconciliation methodology of the accounting records to aggregate foreign reserves data by April 2002.

The on-site assessment noted the **absence of a benchmark financial reporting framework,** coupled with inconsistent accounting treatment for certain balances, **and insufficient disclosures** in the explanatory notes of the financial statements. Transparency is also impaired by the **long delay in the publication of the financial statements**. Staff recommended (i) the application of International Accounting Standards by the bank with effect from the financial-year 2002, (ii) the finalization of the audited financial statements within six months of the financial year's end, as required by the law, and (iii) the publication of the full financial statements (including the explanatory notes) in the NBE annual report.

Several late payments to the Fund by the NBE have occurred, sometimes for reasons beyond the NBE's control. In order to prevent future late payments, the NBE agreed to take advantage of the standing authorization process for all IMF payments. The staff noted the need for capacity building within the NBE to implement the recommended safeguards assessment measures, and the authorities would welcome the assistance of a **long-term technical assistance expert**.

INTERNATIONAL MONETARY FUND

NEWS BRIEF

FOR IMMEDIATE RELEASE

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

IMF Completes Second Review Under Ethiopia's PRGF Arrangement and Approves US$30 Million Disbursement

The Executive Board of the International Monetary Fund (IMF) today completed the second review of Ethiopia's performance under the Poverty Reduction and Growth Facility (PRGF) arrangement.[1]

The Board also approved an augmentation of the PRGF arrangement by SDR 13.37 million (about US$17 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. The Board also granted a waiver of the non-observance of the performance criterion on net domestic assets of the National Bank of Ethiopia. As a result of today's decision, Ethiopia will be able to draw a total of SDR 23.80 million (about US$30 million) immediately.

[1] 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 each PRGF-supported program is consistent with a comprehensive framework for macroeconomic, structural, and social policies to foster growth and reduce poverty. In the case of Ethiopia, a full PRSP is in preparation. 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.

Ethiopia's PRGF Arrangement was approved on March 22, 2001 (see Press Release 01/11) for SDR 86.9 million (about US$109 million). So far, Ethiopia has drawn SDR 34.76 million (about US$44 million).

After the Executive Board's discussion on Ethiopia, Mr. Shigemitsu Sugisaki, Deputy Managing Director and Acting Chairman, stated:

"Ethiopia's performance during the first annual program under the Poverty Reduction and Growth Facility (PRGF) arrangement has been commendable. Most of the performance criteria and benchmarks were observed. Thus, despite a deteriorating external environment, real GDP growth for 2000/01 rose to an estimated 7.9 percent, inflation turned negative as a result of a bumper cereal crop and large inflows of food aid, and the external current account deficit fell to 4.2 percent of GDP. The economic situation remains fragile, but the authorities are committed to consolidating the macroeconomic gains and pushing ahead with their reform program.

"Fiscal performance was better than programmed in 2000/01, as lower spending more than offset a small shortfall in revenue. Several measures were implemented to strengthen tax administration and the tax system, and expenditure was re-oriented from defense to the social sectors and poverty alleviation. As a result, poverty-targeted outlays increased. In the monetary and exchange rate areas, steps were taken to start sterilizing excess liquidity, adopt indirect monetary policy instruments, and move toward a market determination of interest and exchange rates. The wholesale foreign exchange auction was replaced by an interbank foreign exchange market in October 2001.

"The policies to be implemented in the second annual program (October 2001- September 2002) should sustain economic performance, despite the continuing difficult world economic environment. Real GDP is projected at 5.8 percent in 2001/02 and 6.0 percent in 2002/03. The external current account is projected to widen to 7.1 percent of GDP in 2001/02 before narrowing to 6.2 percent in 2002/03. To mitigate the impact of the continued deterioration of the terms of trade for Ethiopia and of the events of September 11, 2001, the Fund is augmenting Ethiopia's access under the PRGF arrangement by 10 percent of quota (SDR 13.37 million). The overall fiscal deficit, including grants and special programs, is to be limited to 9.1 percent of GDP in 2001/02, and 7.8 percent in 2002/03. Further progress is to be made in tax administration reform and in preparation for the introduction of the value-added-tax by January 2003. The authorities plan to cut defense spending further, while poverty-targeted outlays will increase. A comprehensive plan to enhance budget formulation, execution, and reporting will be carried out.

"Reforms are to be implemented to strengthen the financial sector and improve its competitiveness, particularly to improve the financial situation of the largest state-owned bank, the Commercial Bank of Ethiopia. Other structural reforms to be pursued in 2001/02 include public sector capacity-building, privatization and other efforts to attract foreign investment and develop the private sector, and further strengthening of the legal and regulatory framework," Mr. Sugisaki said.