July 2008
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The Federal Democratic Republic of Ethiopia: 2008 Article IV Consultation—Staff Report; Staff Supplement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for The Federal Democratic Republic of Ethiopia.

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2008 Article IV consultation with The Federal Democratic Republic of Ethiopia, the following documents have been released and are included in this package:

- The staff report for the 2008 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on July 1 2008, with the officials of The Federal Democratic Republic of Ethiopia on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on July 1, 2008. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- A staff supplement on the joint IMF/World Bank debt sustainability analysis.

- A Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its July 14, 2008 discussion of the staff report that concluded the Article IV consultation.

- A statement by the Executive Director for The Federal Democratic Republic of Ethiopia.

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

Selected Issues Paper
Statistical Appendix

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

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INTERNATIONAL MONETARY FUND

THE FEDERAL DEMOCRATIC REPUBLIC OF ETHIOPIA

Staff Report for the 2008 Article IV Consultation

Prepared by the Staff Representative for the 2008 Consultation
with the Federal Democratic Republic of Ethiopia

Approved by Saul Lizondo and Martin Fetherston

July 1, 2008

- At the conclusion of the Last Article IV consultation on June 2, 2007, Executive Directors, welcomed Ethiopia's strong growth, but called for measures to address the incipient macroeconomic imbalances and to intensify structural reforms.
- Discussions for the 2008 Article IV consultation were held May 7–19, 2008. The mission met with Prime Minister Meles Zenawi, Minister of Finance and Economic Development Sufian Ahmed, Central Bank Governor Teklewold Atnafu, senior officials, and representatives of civil society and the donor community. The mission team comprised Messrs. Corker (head), Honda, Zhan (all AFR), and Thomas (PDR). Mr. Schwidrowski (Senior Resident Representative) assisted the mission. Mr. Uanguta (OED) attended most of the meetings. The mission collaborated with the World Bank and African Development Bank missions in Addis Ababa.
- In light of recent market developments, staff has reclassified the de facto exchange rate regime as a crawling peg. The authorities describe the regime as a managed float with no predetermined path for the exchange rate.

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EXECUTIVE SUMMARY

- Ethiopia's pro-growth development policies have helped sustain average growth of 11 percent since 2003/04, consistent with the goal of reducing poverty. In recent years, however, it has become clear that demand is running ahead of the expansion in the capacity of the economy. Inflation increased to almost 40 percent on a 12-month basis in May 2008. International reserves have fallen to about 1.5 months of imports.

- Inflation is being led by rapidly rising food prices. Rising global prices are playing a role. However, because the amount of non-aid food imports is relatively small, the mechanism is not clear and other domestic factors also lie behind Ethiopia's inflation.

- The surge in world oil prices is placing further strain on Ethiopia's balance of payments. On a full-year basis, the rise in oil prices will increase the imported oil bill by about US$1 billion (3 percent of GDP).

- The authorities are aiming to address the macroeconomic imbalances as well as to absorb the severe world oil price shock, in a manner that will least affect the momentum for growth and poverty reduction. They plan to reduce broad money growth to under 20 percent and support lower monetary growth by implementing a cautious fiscal policy that keeps domestic borrowing well within the budget ceiling.

- Staff urges forceful measures to prevent inflation expectations from becoming ingrained and to strengthen the balance of payments. It supports the proposed tightening of monetary policy and recommends a halving of public sector borrowing to 2-3 percent of GDP in 2008/09, including through closer control over the activities of public enterprises. Overall public sector borrowing has risen to about 5 percent of GDP in the last two years, in part because of high expenditure by public enterprises. Further tightening measures will be required if inflation does not begin to turn down.

- Policies to facilitate necessary adjustment to the oil price shock and to lower inflation are likely to reduce economic growth, at least in the short term. Additional donor financial support would help lessen the adverse impact on poverty reduction.

- The real exchange rate has appreciated significantly in recent years. Thus, although exports have been growing strongly, competitiveness will need to be kept under review and more nominal exchange rate flexibility considered.

- Financial sector development will be important to maintain strong economic growth. Measures to promote competition in the banking sector will need to be explored. The soundness of the banking system will require careful monitoring as any slowdown in the economy could expose credit quality problems.

I. Background and Recent Developments

1. **The Ethiopian economy has grown rapidly in the last four years, despite continuing regional political tensions.**[1] Favorable weather conditions and pro-growth development policies—with an emphasis on public investment, commercialization of agriculture, and nonfarm private sector developments—have helped sustain recovery from the sharp drought-related contraction in 2002/03 (Table 1).[2] Growth has averaged 11 percent since 2003/04, far exceeding the minimum growth target of 7 percent in the Program for Accelerated and Sustainable Development (PASDEP), that is estimated to be consistent with keeping the Millennium Development Goals (MDGs) within reach.[3]

2. **Over this period, Ethiopia has continued its transition to a market economy, although some sectors have yet to be fully liberalized.**[4] Public enterprises still play a major role in many areas, including the financial, energy, and communication sectors. Market pricing is not fully functioning in the financial sector where interest rates are not responsive to changes in demand and supply conditions.

3. **In recent years, it has become clear that demand is running ahead of efforts to expand the capacity of the economy through public investment in physical and social infrastructure investment and through private entrepreneurship**. Inflation rose to 39 percent in the twelve months to May 2008 with food price inflation reaching 54 percent (Box 1). International reserves fell to 1.5 months of imports at end-April 2008.

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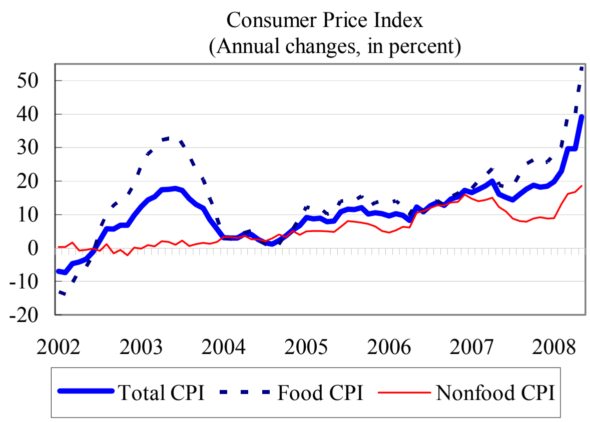
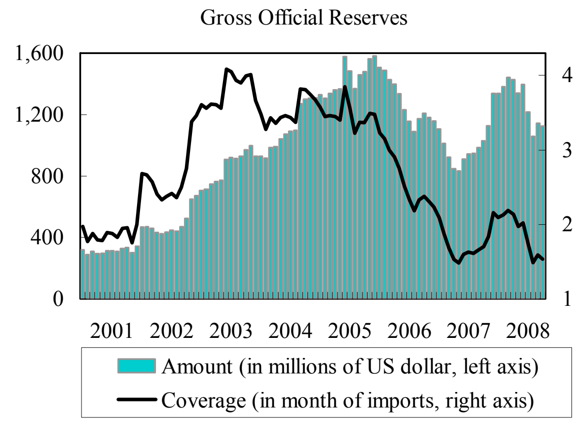
[1] Ethiopian troops remain engaged in Somalia and tensions with Eritrea remain high following the expiration of the border agreement in November 2007.

[2] The fiscal year runs from July 8 to July 7.

[3] Up-to-date information on poverty is sparse. According to the authorities' estimates, the total poverty head count fell to 34.6 percent of population by end-2006/07 from 39 percent in 2004/05.

[4] For details of reforms begun in the early 1990s, see "The Federal Democratic Republic of Ethiopia: Ex Post Assessment of Long-Term Fund Engagement, January 2005" (http://www.imf.org/external/pubs/cat/longres.cfm?sk=18010.0).

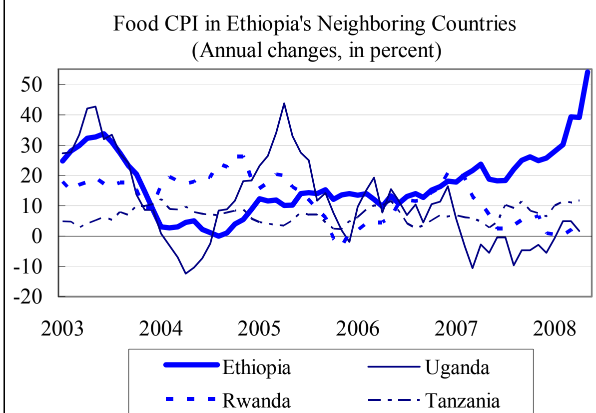


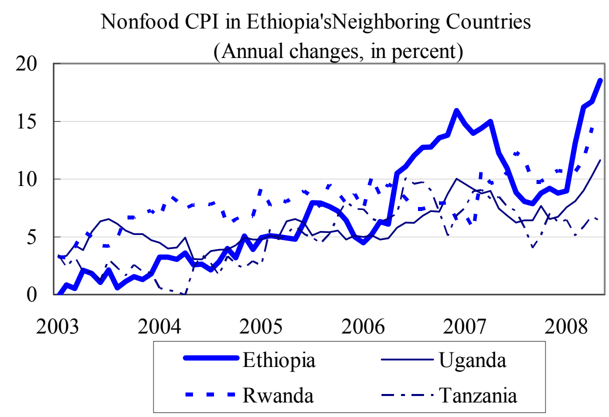


4. **Economic growth may be slowing but remains high**. The authorities consider that agricultural production is continuing to expand rapidly, notwithstanding the poor performance of the short rainy season in some regions, and expect broad-based growth of 11 percent in 2007/08, with significant contributions from manufacturing, construction, and services. However, tempered by estimates that export and import growth has slowed to 4–9 percent in real terms, staff projects real GDP growth is closer to 8½ percent.

Box 1: Causes of Recent Inflation

Both domestic and external factors account for the recent increase in inflation. Estimating the impact of each factor is difficult, given continuing structural changes, but higher inflation than in neighboring countries points to some Ethiopia-specific factors and imbalances, including from demand pressures and increasing inflation expectations. The direct impact through global food price hikes has been limited in light of the small import share of non-aid food.





Some supply-side factors probably explain part of the rise in food prices: (i) farmers have recently been equipped with better access to credit, storage facilities, marketing information and income, leading to better negotiation powers for higher prices, (ii) the total supply of cereals has fallen as some donors have switched from food to cash aid; and (iii) local food prices may be converging to high (and rising) world grain prices. However, the mechanism of the last of these factors is unclear. One possibility is that convergence to world prices is being driven by unofficial food exports attracted by high food prices in neighboring countries.

5. **The rise in world oil prices is hitting Ethiopia's economy hard**. Although surging coffee prices have helped limit the impact on the terms of trade, and private remittances have risen sharply, the higher oil and fertilizer import bill is placing considerable pressures on international reserves (Table 5). The inflationary impact of high oil prices has so far been relatively contained as they have only been partially passed through to consumers. This has resulted in sizable government subsidies (estimated at about 1 percent of GDP), which are being provided off-budget through the Oil Stabilization Fund.[5]

6. **Overall public sector borrowing has remained high in part because of heavy public enterprise expenditures.** In 2006/07, the general government fiscal balance (including grants) improved because of cuts in spending and increases in grants (Tables 2 and 3). For 2007/08, helped by some revenue measures (notably, the introduction of an import surcharge on consumer goods) and increased external financing and privatization revenues, domestic financing of the general government is being contained below the 2.5 percent of GDP budget target. In this context, measures to alleviate the impact of high food price inflation—the lifting of VAT, turnover tax, and surtaxes on some food items—have been limited. But with significant borrowing by public enterprises, staff estimates that overall domestic public sector borrowing would reach 5 percent of GDP for 2007/08 compared with 4.8 percent in 2006/07 (Box 2).

[5] For some petroleum products (gasoline, kerosene and diesel), staff estimates that as of May 2008 further upward price adjustments by about 25-50 percent would be needed to fully recover costs.

Box 2. Public Enterprise Investment

A key element of Ethiopia's growth strategy is to rapidly scale up infrastructure investment in power, telecommunication and transport. The power company is in the process of building five new hydro-power plants and one wind-power plant with an installed capacity of over 3,000 MW by 2012, compared with Ethiopia's current installed capacity of 663 MW. The telecommunications company is expanding the mobile phone coverage with plans for coverage of 6 percent of population by 2009/10. The national airline has put in a request for up to 10 Dreamliner planes for delivery between 2009 and 2012. Future financing for these projects is mostly confined to external funds (partly on nonconcessional terms), but some domestic financing from commercial banks has recently been used.

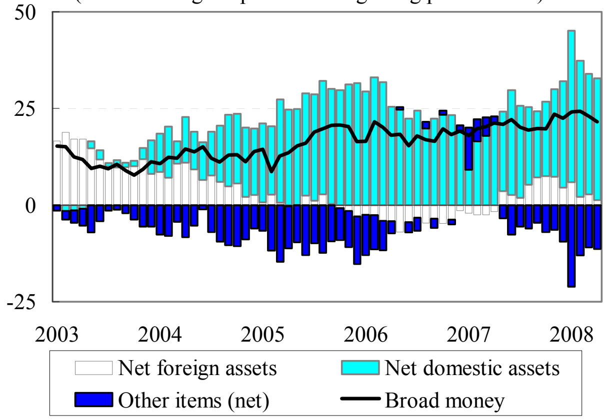
Financing to Public Enterprises
(in percent of GDP)

	2006/07 Act	2007/08 Proj.	2008/09 Proj.	2009/10 Proj.	2010/11 Proj.
Major public enterprises 1/	1.9	2.4	5.5	4.0	2.9
External financing	0.5	0.7	2.6	2.5	2.4
Domestic financing	1.5	1.3	1.0	0.0	0.0
Unidentified financing 2/	0.0	0.4	1.9	1.5	0.6
Other public enterprises	0.2	1.2	n.a.	n.a.	n.a.
Total financing to public enterprises	2.2	3.6	n.a.	n.a.	n.a.

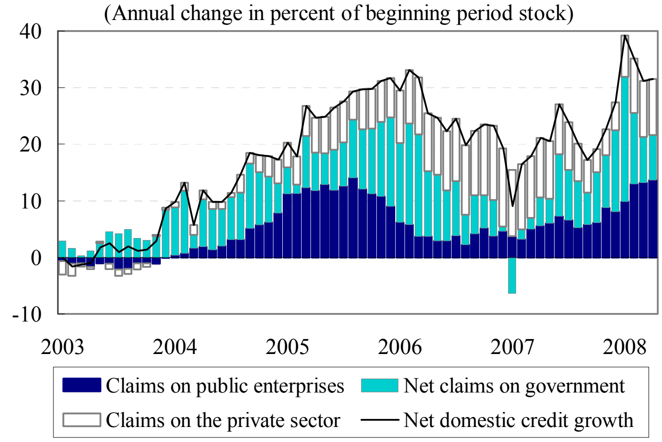
Sources: Ethiopian authorities, ETC, EEPCo, EAL, and staff estimates.
1/ The Ethiopian Telecommunications Corporation (ETC), the Ethiopian Electric Power Corporation (EEPCo), and Ethiopian Airlines Enterprise (EAL).
2/ Unidentified financing is a residual between planned investments and identified financing.

7. **Credit expansion to the public sector has to a large extent also driven relatively rapid broad money growth (Table 4 and figures below)**. The National Bank of Ethiopia (NBE) raised minimum reserve requirements on commercial bank deposits from 5 to 10 percent (July 2007), and to 15 percent (April 2008), and raised the minimum time and saving deposit rate from 3 to 4 percent (July 2007). This has helped reduce banks' excess reserves and slow private sector credit growth somewhat. But broad money growth has been propelled by credit to the public sector, particularly to public enterprises, while the NBE resumed the provision of direct advances to the government in late 2007 in response to commercial banks' request to rediscount treasury bills.

Contribution to Broad Money Growth
(Annual change in percent of beginning period stock)

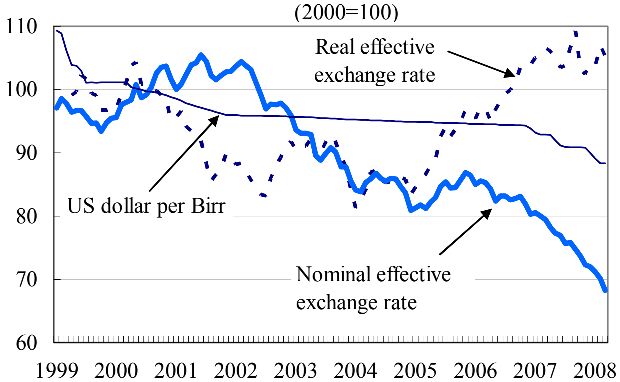


Contribution to Net Dometic Credit Growth
(Annual change in percent of beginning period stock)

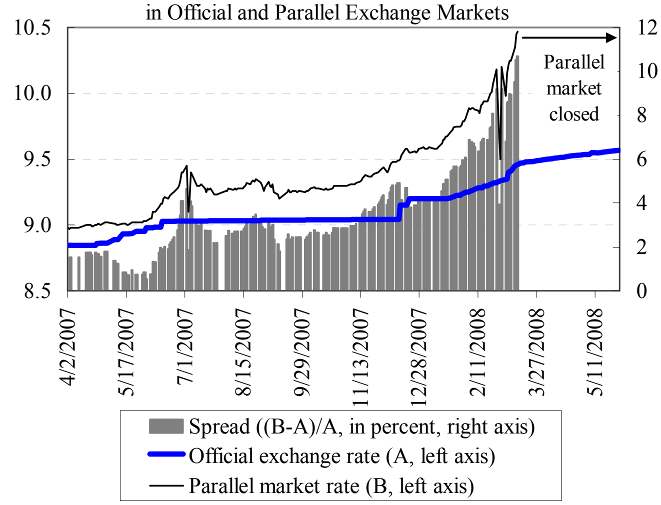


8. **The real effective exchange rate has continued to appreciate.** The official exchange rate for the Birr against the U.S. dollar, and in nominal effective terms has steadily depreciated since end-2007. In parallel markets, the Birr weakened significantly, and the premium widened to 10 percent by mid-March 2008, prompting the authorities to close the markets at the end-March.[6] Nonetheless, the real effective exchange rate has appreciated due to Ethiopia's much faster inflation rate than in its trading partners.

Nominal and Real Effective Exchange Rates
(2000=100)



Exchange Rates (per 1 U.S. Dollar)
in Official and Parallel Exchange Markets



II. Adjusting to Shocks and Imbalances

9. **Discussions focused on how Ethiopia could reduce inflation and adjust to the global food and oil price shocks in a manner that would least affect the momentum for**

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[6] Foreign exchange dealers and other exporters/importers have participated in the parallel market for several years.

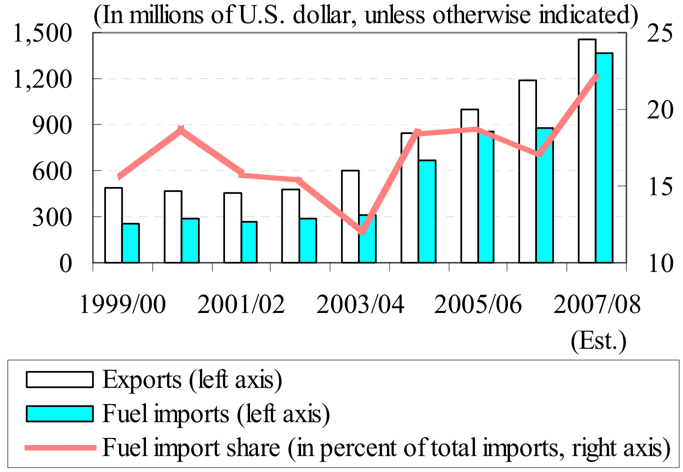
growth and poverty reduction. There was full agreement that the authorities' targets of reducing inflation to single digits and raising international reserve coverage, over time, to 10-12 weeks of imports are consistent with sustaining development over the medium-term. At the same time, policies to achieve a soft landing will have to judiciously balance the risks to growth, inflation, and the balance of payments. The consultation explored these risks and their implications for policies in the period ahead.

Twin challenges

10. **The authorities recognized that the twin challenges of high inflation and low international reserves considerably limited their policy options**. On inflation, the authorities placed somewhat more emphasis on the role of structural factors driving an increase in the relative price of food, but agreed that policies to dampen demand were called for. The authorities in this regard viewed rapidly rising agricultural prices as a mixed blessing: they were expected to encourage a strong supply response, but in the short term had an adverse impact on many vulnerable groups, including the urban poor, and reduced the real value of food aid.[7] On the oil price surge, staff and the authorities agreed that it should be best treated as a permanent, and very large, shock to the balance of payments: in 2008/09 the import bill was expected to be about US$1 billion higher (over 3 percent of GDP) than two years earlier and to persist at its new high level over the medium term. Staff agreed that, in the circumstances, it was unrealistic to rebuild the foreign exchange reserves rapidly, and moving toward the authorities' intermediate target of 8-10 weeks of imports should be the goal in 2008/09.

Fuel Import and Export of Goods

(In millions of U.S. dollar, unless otherwise indicated)



11. **The authorities were hopeful that adjustment to low inflation and high oil prices could be achieved without a significant slowdown in economic growth**. They agreed that monetary and fiscal tightening was a necessary response, but felt that the potential growth of the economy had been raised as a result of past infrastructure investment and reforms, with the export sector in particular likely to make a rising contribution to growth and the balance of payments in the years ahead.

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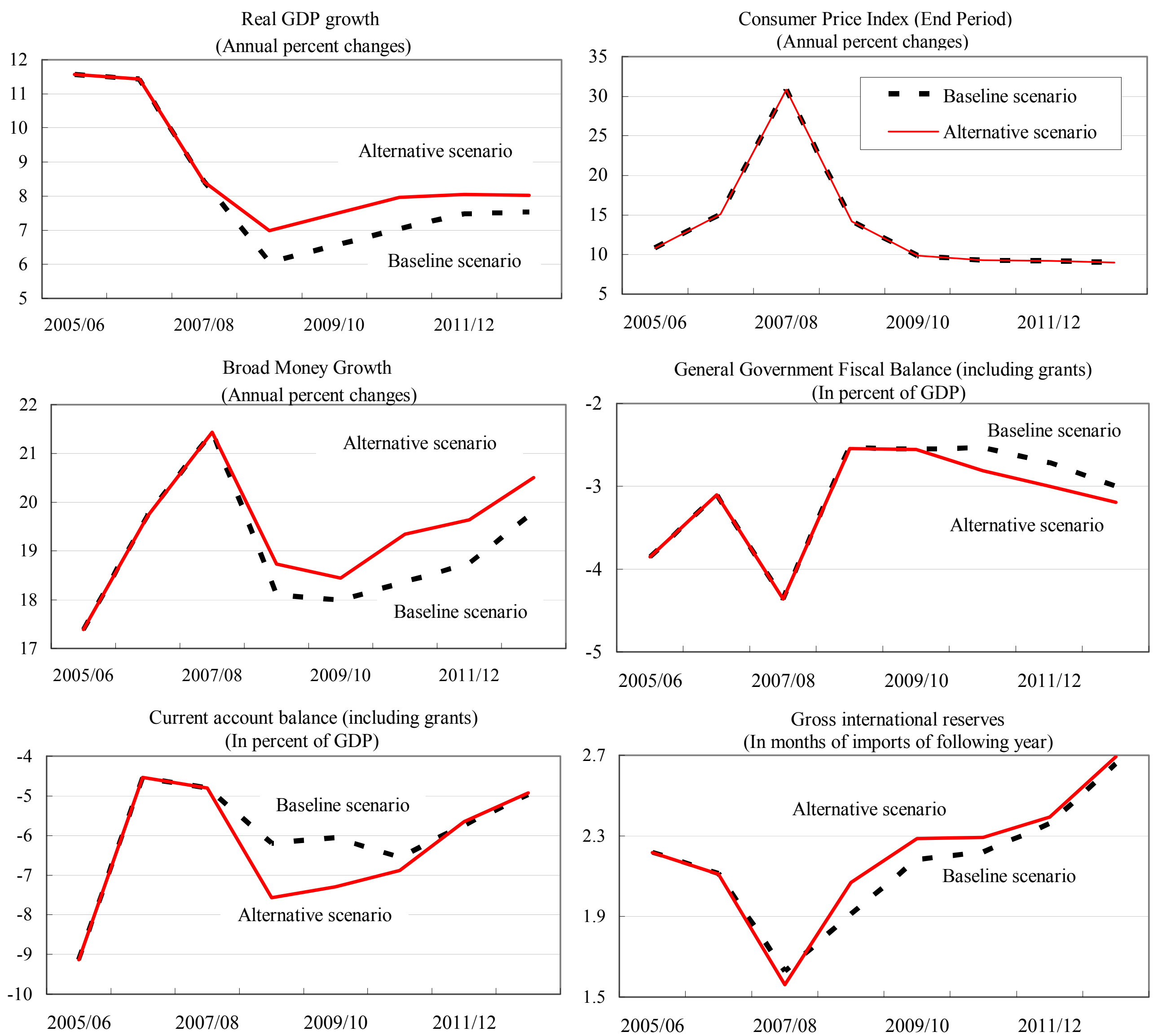
[7] Launched in 2005, the Productive Safety Net Program is providing labor-intensive public works and direct financial support for about 7.4 million beneficiaries. In addition, food subsidies are being provided with an estimated cost of 0.1 percent of GDP in 2007/08.

12. **By contrast, the staff's analysis, summarized in an illustrative baseline medium-term adjustment scenario, suggested that sustainable medium-term growth would be significantly below rates achieved in recent years**. With front-loaded tightening of monetary and fiscal policies, inflation could be brought down to single digits over the course of the next two years. Full pass through of fuel prices would help adjustment to the oil price shock, but given the need to build foreign reserves to 10-12 weeks of imports and pay for higher oil imports, the scope for domestic demand and import growth would be circumscribed in the medium term, notwithstanding strong concessional and nonconcessionsal official inflows. Export growth might be buoyant as the authorities expected—although there were questions about competitiveness (see below)—but given the small size of the export base, staff estimated that average GDP growth would be around 7 percent (the PASDEP floor) in the medium term and lower than this in the near term.

13. **Moreover, staff pointed to considerable downside risks to growth**. There was a risk that inflation expectations were becoming ingrained and more aggressive policy tightening might be required. The external environment might deteriorate or oil prices could rise further.[8] And the scenario abstracts from potential adverse weather effects on agriculture—Ethiopia's growth has benefited in recent years from the absence of severe droughts, which in the past have occurred every 5–6 years. Notwithstanding the authorities efforts to encourage the development and resilience of the agricultural sector, the recurrence of droughts would lead to both high variability of output and inflation as well as lower average growth.

[8] Oil prices are assumed to average US$113 per barrel in the medium term.

Medium-Term Projections—Baseline and Alternative Scenarios



14. **Necessary adjustment therefore posed a serious threat to Ethiopia's efforts to reduce poverty**. Even if the more worrisome downside risks do not materialize, the projected growth slowdown is substantial and budget resources for development and pro-poor spending will be squeezed because of slower growth of tax revenue and the need for tight fiscal policy. Staff argued that policy tightening could not be avoided if high inflation was to be curtailed and demand adjusted over the medium term to accommodate the oil bill: failure to do so could lead to more costly and disorderly adjustment later.

15. **The impact on development and pro-poor spending could, however, be alleviated by additional donor financing as illustrated in staff's alternative scenario**. The scenario assumes just over 1 billion U.S. dollar of additional grants—on top of the already identified financing—concentrated in the next two fiscal years. This would create room for

additional public spending with some finance assumed to be allocated for capital projects that have high import content and raise longer-term growth. Short-term growth is also higher than in the baseline because finance for imports helps alleviate shortages of key commodities.

Staff Medium-Term Projections

(Percent of GDP, unless otherwise indicated)

	2006/07 Act.	2007/08 Proj.	2008/09 Proj.	2009/10 Proj.	2010/11 Proj.	2011/12 Proj.	2012/13 Proj.
Baseline Scenario							
Real GDP growth (annual percent change)	11.4	8.4	6.0	6.5	7.0	7.5	7.5
Consumer price (end period, annual percent change)	15.1	30.8	14.2	9.9	9.3	9.2	9.0
Broad money (annual percent change)	19.7	21.4	18.1	18.0	18.4	18.7	19.8
Net claims on private sector (annual percent change)	27.3	26.3	17.7	15.1	20.9	20.0	15.0
Fiscal balance (including grants)	-3.1	-4.4	-3.5	-3.7	-3.4	-3.4	-3.7
Total revenue (including grants)	17.7	17.3	17.1	17.2	17.2	17.5	17.4
Domestic revenue	12.8	13.1	12.9	12.9	12.8	12.7	12.5
Total expenditure	20.8	21.7	20.6	20.9	20.7	20.9	21.0
Financing	4.3	4.4	3.5	3.7	3.4	3.4	3.7
Domestic financing	3.1	2.4	1.5	1.5	1.5	1.7	2.0
Current account balance (including grants)	-4.5	-4.8	-6.2	-6.1	-6.6	-5.7	-5.0
Gross international reserves (month of imports)	2.1	1.6	1.9	2.2	2.2	2.4	2.7
Net present value (NPV) of external debt-to-exports ratio [1]	48.6	50.9	78.8	100.2	114.8	117.5	119.1
Alternative scenario							
Real GDP growth (annual percent change)	11.4	8.4	7.0	7.5	8.0	8.0	8.0
Consumer price (end period, annual percent change)	15.1	30.8	14.2	9.9	9.3	9.2	9.0
Broad money (annual percent change)	19.7	21.4	18.7	18.4	19.3	19.6	20.5
Net claims on private sector (annual percent change)	27.3	26.3	14.5	20.1	21.1	18.6	15.3
Fiscal balance (including grants)	-3.1	-4.4	-3.5	-3.7	-3.7	-3.7	-3.8
Total revenue (including grants)	17.7	17.3	17.1	17.1	17.1	17.4	17.2
Domestic revenue	12.8	13.1	12.9	12.8	12.8	12.7	12.5
Total expenditure	20.8	21.7	20.5	20.8	20.8	21.0	21.0
Financing	4.3	4.4	3.5	3.7	3.7	3.7	3.8
Domestic financing	3.1	2.4	1.5	1.5	1.8	2.0	2.2
Current account balance (including grants)	-4.5	-4.8	-7.6	-7.3	-6.9	-5.7	-4.9
Additional donor financing (in millions of U.S. dollars)	0	0	589	420	139	0	0
Gross international reserves (month of imports)	2.1	1.6	2.1	2.3	2.3	2.4	2.7
Net present value (NPV) of external debt-to-exports ratio [1]	48.6	50.9	71.9	88.3	98.5	100.0	101.2

1. After enhanced HIPC relief. Exports of goods and services used.

Adjustment, the real exchange rate and external debt sustainability

16. **An appreciating real exchange rate is beginning to raise questions about competitiveness, although the authorities were confident that exports would remain strong**. Ethiopia's export market shares, for example, have increased in recent years, pointing to productivity advances and broader improvements in supply and business conditions that are not reflected in CPI-based measures of the real effective exchange rate (REER). However, with Ethiopian inflation continuing to run ahead of that in competitor countries, the REER has moved above historical levels.

17. **Staff analysis points to some potential overvaluation of the REER, although there are several qualifications**. Forward-looking analysis of the sustainable current

account deficit, for example, suggests that some real depreciation of the exchange rate might be necessary to support balance of payments adjustment. However, estimates are highly sensitive to assumptions about what is a reasonable medium-term pace of reserves accumulation to underpin external stability, the availability of external financing, and the degree of domestic imbalance in the economy.[9] Likewise, estimates of the fundamental equilibrium REER are sensitive to specification uncertainties with some evidence that earlier debt relief has until recently compensated for the adverse impact on the equilibrium REER of the terms of trade decline, and the actual REER has closely followed its equilibrium level.

18. **The authorities agreed that an active structural reform program is needed to improve productivity and efficiency so as to strengthen external competitiveness**. The PASDEP calls for a range of public investment and services to (i) expand investments in farm-to-market roads; (ii) encourage private sector involvement; (iii) build agricultural credit markets; and (iv) enhance the security of land tenure. Staff pointed to the importance of stimulating private sector development (with special attention to the investment climate) and building the financial sector in light of recent declines in the private investment rate.

19. **The updated debt sustainability analysis incorporating borrowing by some of the major public enterprises shows a moderate risk of debt distress**. Under the baseline scenario, the risk of debt distress is low, but stress tests point to breeches of the threshold on the NPV of debt to exports if new public sector loans are negotiated on less favorable terms, export growth is lower than the historical average, and simultaneous adverse shocks apply to growth, exports and grants. To limit these risks, staff stressed that securing grant and concessional financing and containing domestic borrowing remained vital and urged the authorities to draw up a comprehensive public debt strategy that specifically includes public enterprise debt and contingent liabilities, and to strengthen debt management capacity.

Monetary policy tightening

20. **In view of the still high growth of broad money after the initial monetary tightening, the authorities were stepping up their tightening efforts**. The initial measures had helped to significantly reduce excess reserves of commercial banks, and improve the efficacy of monetary policy instruments, with better control over liquidity developments. However, money growth remained buoyant in the first half of 2008 with the surge in credit to public enterprises and the temporary resumption of NBE direct advances to the government (which replaced treasury bills held by commercial banks). The authorities concurred with staff that central bank advances to the government would need to be contained, and the sale of treasury bills facilitated by attracting more market participants possibly through higher Treasury bill interest rates.

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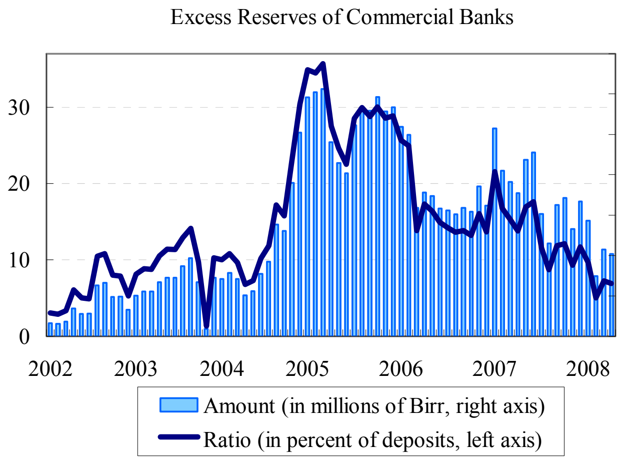
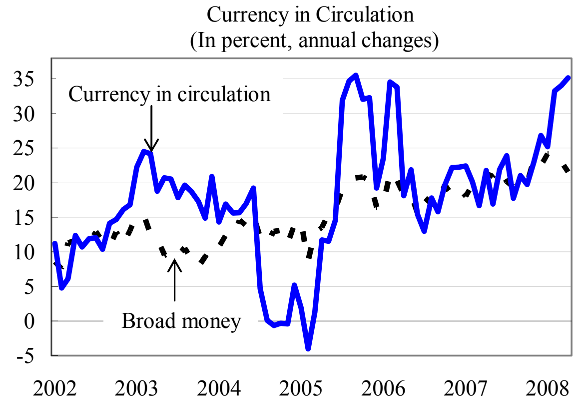
[9] See Chapter III of the SIP for more details. The range of estimates runs from undervaluation of 8 percent to overvaluation of 25 percent.



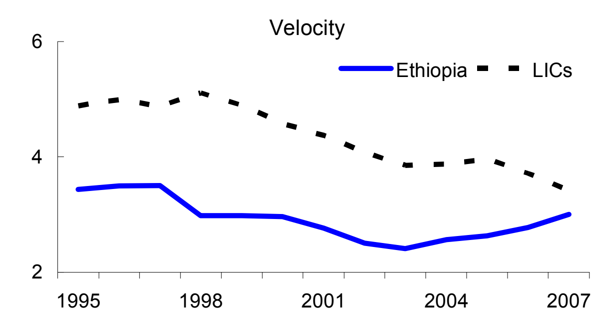


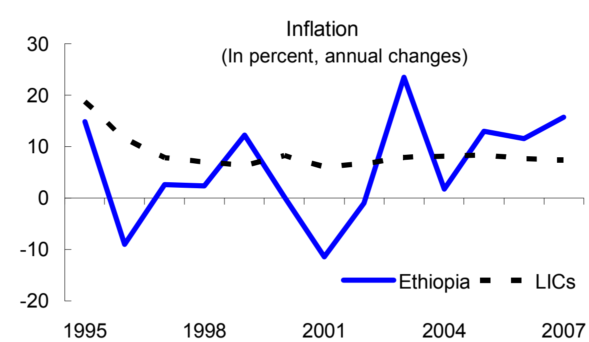
21. **The money growth target for 2008/09 is relatively conservative, but needs to be kept under close review especially if high inflation persists**. The authorities' broad money target of under 20 percent appropriately factors in a rise in money velocity (Box 3). However, setting the money target was further complicated by the uncertainties surrounding the inflation process. Staff agreed that underlying inflation was likely significantly below the headline rate because food price inflation was partly driven by convergence to world prices, a process that had finite (albeit uncertain) limits. Nevertheless, there remained a significant risk that excess demand and inflation expectations were driving inflation, in which case the authorities needed to stand ready to tighten monetary policy further.

Box 3. Ethiopia: Rising Income Velocity of Money

Broad money velocity typically trends downward in low income countries (LICs), reflecting monetization and financial deepening. Against this backdrop, the NBE has set monetary targets under the assumption that velocity declines by about 2 percent each year.

However, in recent years, double-digit inflation, substantially above the LIC average, has eroded the birr's purchasing power as well as its credibility as a store of value. With interest rates also highly negative in real terms, there has been a shift from deposits to cash and from saving to consumption. This has caused monetary deepening to stall, with broad money velocity in 2006/07 increasing by 8 percent.



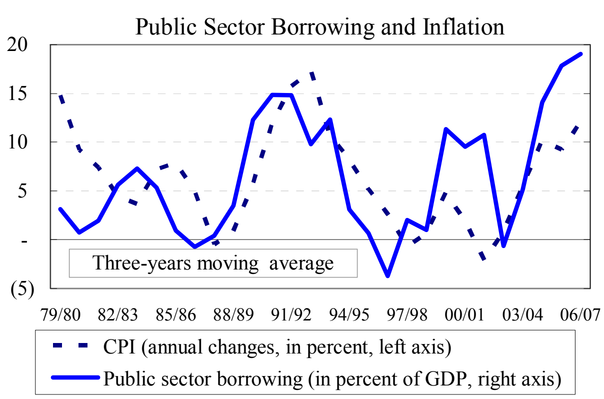


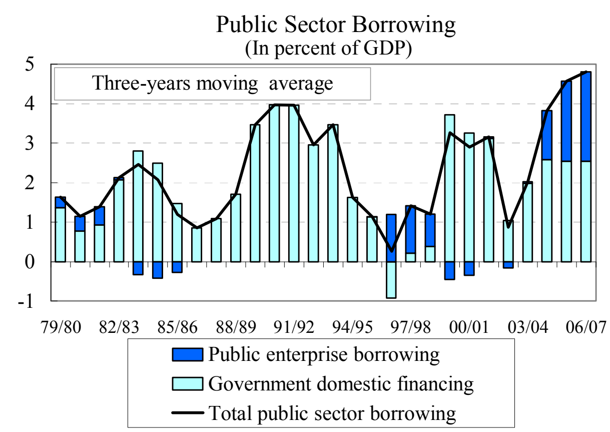
Fiscal support for adjustment

22. **The authorities recognized the need to support monetary tightening with a reduction in public sector domestic borrowing**. With some rebuilding of net foreign assets, the money supply target would imply a sharp decline in private sector credit in 2008/09 if public borrowing were not curtailed. This would lead to imbalanced development and slower output growth. In this context, staff recommended roughly halving domestic public sector borrowing to 2–3 percent of GDP in 2008/09, a level that was also historically consistent with single-digit inflation (Box 4). To the extent that this might require lowering the budget domestic borrowing ceiling to 1½ percent of GDP, real government expenditure growth would be negligible in 2008/09 absent measures to strengthen tax revenue. This would place additional emphasis on the need for careful project selection that emphasizes productivity and contribution to growth as well as prioritization to preserve pro-poor spending.

Box 4: Inflation and Role of Public Sector

Public sector borrowing (defined to include the borrowing by public enterprises from the banking system) is highly correlated with inflation, reflecting the dominant role of the sector in the economy. During previous disinflation periods (late-1980s and mid-1990s), inflation was lowered by 8–18 percentage points, following the reduction of public sector borrowing by 1½–4½ percent of GDP. This is broadly in line with the empirical results of cross-country analysis.[10] Based on this experience, borrowing would need to be reduced by 2–3 percent of GDP to help achieve single-digit inflation.





23. **While the authorities expressed their intention to limit overall public borrowing, they were concerned that going as low as 1½ percent of GDP for domestic**

[10] Fischer et al. (2002), using a panel data of 94 developing countries, estimate that, for high inflation countries, a 1 percentage point improvement in the ratio of the fiscal balance-to-GDP typically leads to a 4.2 percent decline in inflation, all else constant.

budget borrowing would imply too large a squeeze on government spending and the investment budget. Nevertheless, until there were clear signs that inflation was turning, they intended to keep domestic borrowing well below the 2007/08 budget ceiling of 2½ percent of GDP and implement import-intensive capital spending cautiously to mitigate the impact on the external position. At the same time, the top economic policy makers, who now meet regularly to coordinate the macroeconomic policy strategy, would keep a close eye on the activities of public enterprises.

24. **Staff reiterated that, if strong control over the activities of public enterprises is not feasible, budget policy would have to react to pressures on domestic borrowing**. Effective controlling measures—including the introduction of performance contracts and/or approval of their budgets and borrowing plans—should be explored. It also stressed that allowing full pass through of oil prices should be part of the strategy in order to reduce the growing quasi-fiscal liability of the Oil Stabilization Fund. The authorities noted their intention to raise fuel prices further.

25. **The need to keep fiscal policy tight in the medium term to help the economy absorb the oil price shock puts the spotlight on the poor performance of revenues**. The tax-to-GDP ratio has been on a downward trend in recent years because the rebounding agricultural sector is lightly taxed and newly emerging sectors in services and industry benefit from tax breaks. Unless the trend is reversed, the budget arithmetic would become increasingly difficult going forward. Therefore, the authorities were undertaking a comprehensive study of tax reforms, based on earlier technical assistance recommendations.

26. **Improved public financial management would also ensure greater value for money in public expenditure**. Staff welcomed progress in performance budgeting and also encouraged the authorities to seek help from development partners to strengthen the vetting and selection of capital projects.

Exchange rate policy

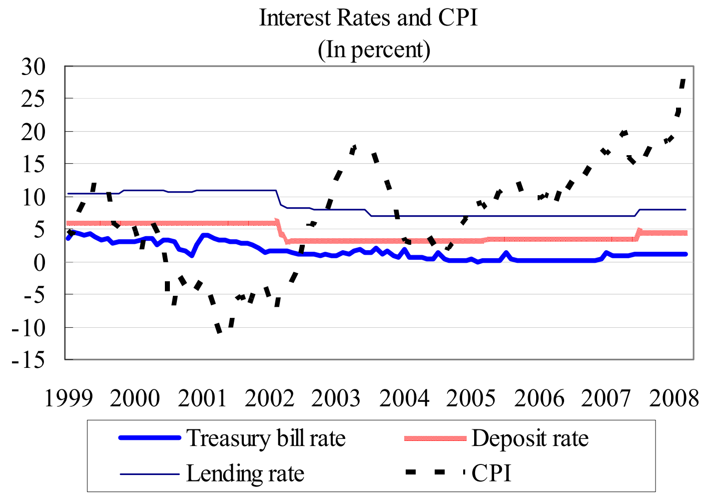
27. **The staff argued that greater exchange rate flexibility is needed to better reflect demand for and supply of foreign exchange**. Absent effective competition in the interbank foreign exchange market, and with the central bank the major supplier of foreign exchange, exchange rate movements have been highly circumscribed.[11] However, in light of potential strains on competitiveness and the need to adapt to higher oil prices, staff stressed it was important to avoid overvaluation. Moreover, the wide spread that had opened up in the parallel market suggested supply and demand imbalances, and the closure of the market could push some transactions further underground, possibly resulting in a wider exchange rate premium. The authorities agreed that more flexibility could in principle be beneficial,

[11] The exchange rate system most closely resembles a crawling peg, although there is no pre-announced target.

but were anxious to avoid sharp corrections of the exchange rate—not least, because they could fan inflation expectations. They agreed to consider measures to foster a more liquid and flexible interbank foreign exchange market, such as allowing banks to bid for foreign exchange more freely.

Financial sector soundness and development

28. **Staff reiterated that increasing competition in the banking sector is central to improving the environment for implementing monetary policy and encouraging private sector development**. Private sector commercial banks have grown in importance in recent years, but even so the state-owned Commercial Bank of Ethiopia (CBE) still accounts for about two thirds of banking system assets. The concentrated nature of the system, along with the significant role of the public sector in the system, partly explains lack of competition for deposits and loans and a distorted interest rate structure.



29. **The authorities remain reluctant to open the banking system to foreign competition and to privatize the CBE**. However, they took note of staff suggestions to allow banks to explore commercial links with foreign partners, which might lead to the development of new financial products and cost savings that would reduce high spreads between lending and deposit rates and fees/charges for financial services.

30. **Financial sector soundness indicators are not signaling problems, but because this is probably the high point of the economic cycle, continued close scrutiny by supervisors will be important (Table 7)**. A slowdown of economic growth and unwinding of high inflation could expose credit risks, particularly as interest rates have been highly negative in real terms. The implications of quasi-fiscal liabilities in the banking system should also be carefully examined in any process of normalizing interest rates.

III. Staff Appraisal

31. **Ethiopia's growth performance has been impressive, but macroeconomic imbalances are intensifying**. Double-digit growth has enabled Ethiopia to keep achievement of the MDGs within reach. High growth, however, has led to increasing pressures on prices and international reserves, which if not firmly addressed will threaten the sustainability of development.

32. **The surge in oil prices also threatens Ethiopia's ability to sustain poverty reduction**. The size of the shock is very large and comes at a time when international reserves are already low. Assuming that oil prices will not come down significantly from their record levels, Ethiopia has no choice but to adjust demand to accommodate the increase in the oil bill. Continued efforts to strengthen the supply side of the economy and encourage exports will help, but full pass through to domestic fuel prices will also be needed as well as tight monetary and fiscal policies in the period ahead. Absent additional donor assistance to help ease adjustment costs, there is thus a strong likelihood of a significant setback to Ethiopia's progress in reducing poverty.

33. **After a tentative start to addressing imbalances, the recent strengthening of policy coordination at the top and articulation of a consistent macroeconomic policy framework are thus welcome**. It will be particularly important to implement a balanced mix of fiscal and monetary policies. This will require implementing all necessary measures to achieve the appropriately tight monetary target and supporting it with a significant reduction of public sector borrowing to 2–3 percent of GDP. Careful monitoring and controlling of the activities of the public enterprises will in this context be essential.

34. **With the risk of inflation expectations becoming ingrained and foreign reserves at a low level, policy tightening will need to be forcefully implemented**. The authorities should implement their budget cautiously in the first half of 2008/09 and ensure that domestic borrowing is kept well below 2½ percent of GDP. Direct advances by the NBE to the government, which automatically create liquidity, should be avoided and Treasury bill rates should be allowed to rise if heavy liquidity mopping up needs arise. The authorities should stand ready to tighten policies further if inflation does not begin to subside quickly and international reserves do not begin to recover.

35. **Tax and expenditure reforms will be needed to alleviate pressures on the budget over the medium term and ensure value for money in public spending**. To reverse the declining tax-to-GDP ratio, the current study on tax reform should be swiftly completed, and reforms implemented without delay. The authorities are also encouraged to strengthen expenditure controls in order to cut low-priority outlays, while safeguarding poverty-reducing expenditures.

36. **Careful attention will need to be paid to external competitiveness in light of the fragility of the balance of payments**. While it is not clear that the exchange rate is overvalued, the risks lie in this direction. The authorities are thus encouraged to permit more exchange rate flexibility, including by fostering a deeper and more competitive foreign exchange market. Longer term, competitiveness will need to be supported by ongoing structural reforms that improve productivity and efficiency in the export sector. While the debt sustainability analyses show a moderate risk of debt distress, securing grant and concessional financing and containing domestic borrowing are vital in order to stay sustainable over the medium to long term.

37. **The financial system will require careful monitoring**. If, as is likely, this is the high point of the current economic cycle, a slowdown in growth and inflation could expose credit risks. Development of the banking system is in any case a structural policy priority in order to provide more access to financing for the private sector. In this regard, more competition among banks is needed, including through further diminishing the market share of the CBE and exploring partnerships with foreign financial institutions.

38. **The data provided to the Fund are adequate for surveillance purposes, but further steps should be taken to address shortcomings in real, fiscal, and balance of payments statistics**. Stepped-up efforts, with technical assistance from various sources (including the Fund), are called for. In the meantime, the authorities should be commended for preparing the statistical appendix for Article IV consultations.

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

Table 1. Ethiopia: Selected Economic and Financial Indicators, 2005/06–2012/13 [1]

	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13
			Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
	(Annual percentage change)							
National income and prices								
GDP at constant prices (at factor cost)	11.6	11.4	8.4	6.0	6.5	7.0	7.5	7.5
Consumer prices (period average)	12.3	15.8	22.4	22.2	12.9	9.3	9.2	9.0
Consumer prices (end period)	10.8	15.1	30.8	14.2	9.9	9.3	9.2	9.0
External sector								
Exports, (In U.S. dollars, f.o.b.)	18.1	18.6	23.0	13.4	9.4	11.4	10.8	11.7
Imports, (In U.S. dollars, c.i.f.)	29.5	12.4	20.9	20.6	10.3	10.5	9.5	8.8
Export volume	5.1	11.3	3.9	11.2	10.8	10.4	9.8	10.7
Import volume	21.2	3.3	7.5	8.0	8.3	9.5	8.5	7.8
Terms of trade (deterioration –)	4.4	-1.7	5.0	-9.3	-3.3	0.0	0.0	0.0
	(Annual percentage change, unless otherwise indicated)							
Money and credit								
Net foreign assets	-4.6	5.1	0.5	37.2	35.3	21.3	25.9	31.6
Net domestic assets	28.9	25.4	28.2	13.3	12.7	17.3	16.0	14.9
Net claims on the government	12.5	16.3	18.5	12.3	13.2	13.7	16.0	19.0
Net claims on public enterprises	33.0	36.7	46.0	9.3	10.0	15.1	6.2	1.2
Net claims on private sector	28.3	27.3	26.3	17.7	15.1	20.9	20.0	15.0
Broad money	17.4	19.7	21.4	18.1	18.0	18.4	18.7	19.8
Velocity (GDP/broad money)	2.77	3.01	3.32	3.61	3.66	3.62	3.57	3.49
	(In percent of GDP, unless otherwise indicated)							
Financial balances								
Gross domestic saving	3.7	5.6	4.1	4.6	4.0	3.5	3.9	3.9
Government saving	2.7	1.3	1.0	2.0	1.8	1.7	1.6	1.5
Private saving	0.9	4.4	3.1	2.6	2.2	1.8	2.3	2.4
Gross domestic investment	24.2	25.0	21.9	21.9	21.5	22.4	22.9	22.3
Public investment	16.7	18.2	15.6	15.2	15.0	14.6	15.0	14.5
Private investment	7.6	6.7	6.3	6.7	6.5	7.8	8.0	7.8
Resource gap	-20.6	-19.3	-18.2	-17.3	-17.6	-18.9	-19.0	-18.4
External current account balance, including official transfers	-9.1	-4.5	-4.8	-6.2	-6.1	-6.6	-5.7	-5.0
Government finances								
Revenue	14.8	12.8	13.1	12.9	12.9	12.8	12.7	12.5
External grants	3.6	5.0	4.2	4.2	4.3	4.5	4.9	4.8
Expenditure and net lending	22.3	20.8	21.7	20.6	20.9	20.7	20.9	21.0
Fiscal balance, excluding grants (cash basis)	-7.4	-8.1	-8.6	-7.6	-8.1	-7.9	-8.3	-8.5
Fiscal balance, including grants (cash basis)	-3.9	-3.1	-4.4	-3.5	-3.7	-3.4	-3.4	-3.7
Total financing (excluding residual)	2.5	4.3	4.4	3.5	3.7	3.4	3.4	3.7
External financing	1.1	1.1	1.5	2.0	2.2	1.9	1.7	1.7
Domestic financing (not including privatization)	1.3	3.1	2.4	1.5	1.5	1.5	1.7	2.0
Public debt [3]	68.1	37.9	34.4	35.0	36.8	38.7	40.1	41.5
Domestic debt [2]	30.9	28.4	24.9	21.8	19.6	18.1	16.9	16.2
External debt (including to Fund)	37.3	9.6	9.5	13.3	17.2	20.6	23.2	25.3
Net present value (NPV) of external debt-to-exports ratio (including to Fund) [3]	50.8	48.6	50.9	78.8	100.2	114.8	117.5	119.1
External debt-service ratio [4]	5.0	0.7	0.4	0.4	0.7	1.1	1.4	1.7
Overall balance of payments (in millions of U.S. dollars)	-316	-6	-56	371	451	273	422	658
Gross official reserves (in millions of U.S. dollars)	1,158	1,326	1,239	1,599	2,015	2,245	2,601	3,218
(in months of imports of goods and nonfactor services of following year)	2.2	2.1	1.6	1.9	2.2	2.2	2.4	2.7
GDP at current market prices (in millions of birr)	131,672	170,921	229,229	294,772	352,311	411,788	482,963	565,948

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

1. Except for data on external sector which is based on July 1-June 30, data pertain to the period July 8-July 7.

2. Whole series was revised.

3. Including debt to major public enterprises.

4. After enhanced HIPC and MDRI relief.

Table 2. Ethiopia: General Government Operations, 2004/05–2007/08

(In millions of Birr)

	2004/05	2005/06	2006/07	2007/08
				Staff
	Act.	Act.	Act.	Proj.
Total revenue and grants	20,147	24,250	30,274	39,681
Revenue	15,582	19,529	21,797	30,024
Tax revenue	12,398	14,159	17,354	23,821
Direct taxes	3,930	4,461	5,168	7,090
Indirect taxes	8,468	9,698	12,186	16,731
Domestic indirect taxes	2,721	3,111	3,997	5,352
Import duties and taxes	5,746	6,587	8,189	11,379
Nontax revenue	3,184	5,371	4,444	6,203
Grants	4,565	4,721	8,477	9,657
Emergency assistance (food and nonfood aid)	721	586	411	1,713
Program grants [1]	2,331	950	4,985	4,888
Multilateral Debt Relief Initiative [2]	...	989	...	...
Project grants	1,513	2,196	3,081	3,056
Total expenditure and net lending (cash basis) [3]	24,796	29,325	35,608	49,679
Recurrent expenditure [3]	13,229	15,234	17,166	26,197
Defense spending	2,920	3,009	3,005	3,500
Poverty-reducing expenditure [4]	4,968	6,493	7,795	10,348
Interest payments	1,011	1,054	1,207	1,631
Domestic interest and charges	525	621	727	1,207
External interest payments [5]	486	433	480	424
Emergency assistance (food and other emergency aid)	721	586	411	1,713
Other recurrent expenditure	3,609	4,091	4,748	9,006
Capital expenditure [3]	11,343	14,041	18,398	23,481
Central treasury	8,376	10,785	13,833	17,538
External project grants	1,513	2,196	3,081	3,056
External project loans	1,454	1,061	1,484	2,887
Special programs [6]	224	50	44	0
Overall balance				
Including grants	-4,649	-5,075	-5,334	-9,998
Excluding grants	-9,214	-9,796	-13,811	-19,655
Excluding MDRI	...	-6,064	...	...
Financing	5,886	3,259	7,273	9,998
Net external financing	2,384	1,512	1,916	3,463
Gross borrowing	2,507	1,520	1,774	2,887
Capital budget	1,454	1,061	1,484	2,887
Special programs	273	459	290	0
HIPC debt relief [5]	728	926	1,057	992
Amortization [5]	-851	-934	-915	-416
Total net domestic financing	3,492	1,747	5,357	5,591
Domestic (net)	3,492	2,736	5,357	5,591
Banking system	3,156	2,876	3,369	5,591
Nonbank sources	336	-141	1,988	0
MDRI, account held at NBE [2]	...	-989	...	...
Privatization	10	0	0	944
Float/unidentified financing	-1,237	1,816	-1,939	0
Memorandum items:				
Poverty-reducing expenditure	14,004	18,290	22,366	31,585
Direct budget support (loans plus grants, US$ millions)	360	109	567	524
Multilateral debt relief initiative (US$ millions)	...	114	...	...
External grants and loans (US dollars per capita)	11	10	15	17
Primary fiscal balance, including grants	-3,638	-4,021	-4,127	-8,367
Domestic fiscal balance, including grants	-5,039	-5,520	-8,355	-11,575
Gross domestic government debt	31,911	38,841	44,198	49,789

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

1 Including the disbursements under the PBS operations starting from 2005/06.

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

3 Excluding special programs (demobilization and reconstruction).

4 Poverty-reducing spending is defined to include total spending on health, education, agriculture, roads, and food security.

5 External interest and amortization are presented before HIPC debt relief from the World Bank and African Development Bank.

6 Demobilization and reconstruction.

Table 3. Ethiopia: General Government Operations, 2004/05–2007/08

(In percent of GDP)

	2004/05	2005/06	2006/07	2007/08
				Staff
	Act.	Act.	Act.	Proj.
Total revenue and grants	18.9	18.4	17.7	17.3
Revenue	14.6	14.8	12.8	13.1
Tax revenue	11.6	10.8	10.2	10.4
Direct taxes	3.7	3.4	3.0	3.1
Indirect taxes	8.0	7.4	7.1	7.3
Domestic indirect taxes	2.6	2.4	2.3	2.3
Import duties and taxes	5.4	5.0	4.8	5.0
Nontax revenue	3.0	4.1	2.6	2.7
Grants	4.3	3.6	5.0	4.2
Emergency assistance (food and nonfood aid)	0.7	0.4	0.2	0.7
Program grants [1]	2.2	0.7	2.9	2.1
Multilateral Debt Relief Initiative [2]	…	0.8	0.0	0.0
Project grants	1.4	1.7	1.8	1.3
Total expenditure and net lending (cash basis) [3]	23.3	22.3	20.8	21.7
Recurrent expenditure [3]	12.4	11.6	10.0	11.4
Defense spending	2.7	2.3	1.8	1.5
Poverty-reducing expenditure [4]	4.7	4.9	4.6	4.5
Interest payments	0.9	0.8	0.7	0.7
Domestic interest and charges	0.5	0.5	0.4	0.5
External interest payments [5]	0.5	0.3	0.3	0.2
Emergency assistance (food and other emergency aid)	0.7	0.4	0.2	0.7
Other recurrent expenditure	3.4	3.1	2.8	3.9
Capital expenditure [3]	10.7	10.7	10.8	10.2
Central treasury	7.9	8.2	8.1	7.7
External project grants	1.4	1.7	1.8	1.3
External project loans	1.4	0.8	0.9	1.3
Special programs [6]	0.2	0.0	0.0	0.0
Overall balance				
Including grants	-4.4	-3.9	-3.1	-4.4
Excluding grants	-8.7	-7.4	-8.1	-8.6
Excluding MDRI	…	-4.6	… ..	…
Financing	5.5	2.5	4.3	4.4
Net external financing	2.2	1.1	1.1	1.5
Gross borrowing	2.4	1.2	1.0	1.3
Capital budget	1.4	0.8	0.9	1.3
Special programs	0.3	0.3	0.2	0.0
HIPC debt relief [5]	0.7	0.7	0.6	0.4
Amortization [5]	-0.8	-0.7	-0.5	-0.2
Total net domestic financing	3.3	1.3	3.1	2.4
Domestic (net)	3.3	2.1	3.1	2.4
Banking system	3.0	2.2	2.0	2.4
Nonbank sources	0.3	-0.1	1.2	0.0
MDRI, account held at NBE [2]	…	-0.8	0.0	0.0
Privatization	0.0	0.0	0.0	0.4
Float/unidentified financing	-1.2	1.4	-1.1	0.0
Memorandum items:				
Poverty-reducing expenditure	13.2	13.9	13.1	13.8
Import duties and taxes (as a percentage of imports)	15.2	13.7	14.9	16.2
Direct budget support (loans plus grants, as a percent of GDP)	2.9	0.7	2.9	2.1
Primary fiscal balance, including grants	-3.4	-3.1	-2.4	-3.7
Domestic fiscal balance, including grants	-4.7	-4.2	-4.9	-5.0
Gross domestic government debt	30.0	29.5	25.9	21.7

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

1 Including the disbursements under the PBS operations starting from 2005/06.

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

3 Excluding special programs (demobilization and reconstruction).

4 Poverty-reducing spending is defined to include total spending on health, education, agriculture, roads, and food security.

5 External interest and amortization are presented before HIPC debt relief from the World Bank and African Development Bank.

6 Demobilization and reconstruction.

Table 4. Ethiopia: Monetary Survey, 2004/05–2007/08 [1]

	2004/05	2005/06	2006/07	2007/08
			Est.	Proj.
	(Millions of birr)			
Net foreign assets	13,896	13,251	13,927	13,993
National Bank of Ethiopia (NBE)	9,670	7,312	8,179	7,873
Assets	13,477	9,389	11,807	11,735
Liabilities	3,807	2,077	3,628	3,862
Commercial banks	4,227	5,939	5,748	6,120
Assets	6,133	7,684	7,719	8,218
Liabilities	1,906	1,745	1,971	2,098
Net domestic assets	26,556	34,235	42,932	55,058
Domestic credit	41,652	50,044	61,585	77,538
Claims on government (net) [2]	23,156	26,040	30,290	35,881
NBE	19,071	18,804	24,065	27,896
Commercial banks	4,085	7,236	6,225	7,985
Claims on nongovernment	18,496	24,003	31,295	41,658
NBE	0	0	0	0
Commercial banks	18,496	24,003	31,295	41,658
Public enterprises	5,967	7,936	10,845	15,830
Private sector	12,529	16,069	20,450	25,828
Other items (net)	-15,095	-15,810	-18,653	-22,480
Broad money	40,451	47,486	56,860	69,051
Money	21,429	24,701	29,773	36,222
Currency outside banks	10,063	11,360	13,704	16,740
Demand deposits	11,366	13,341	16,069	19,483
Quasimoney	19,022	22,784	27,087	32,829
Savings deposits	17,403	20,688	23,759	28,794
Time deposits	1,619	2,097	3,328	4,035
	(Annual percent change, unless otherwise indicated)			
Net foreign assets	-0.7	-4.6	5.1	0.5
Net domestic assets	34.0	28.9	25.4	28.2
Domestic credit	31.5	20.1	23.1	25.9
Claims on government (net)	15.7	12.5	16.3	18.5
Claims on nongovernment	58.5	29.8	30.4	33.1
Public enterprises	178.3	33.0	36.7	46.0
Private sector	31.5	28.3	27.3	26.3
Broad money	19.6	17.4	19.7	21.4
Money	18.1	15.3	20.5	21.7
Quasimoney	21.3	19.8	18.9	21.2
Memorandum items:				
Reserve money growth	73.9	-10.2	27.4	11.5
Money multiplier	1.8	2.3	2.2	2.4
Velocity (GDP/broad money)	2.63	2.77	3.01	3.32
Gross official foreign reserves (US$ millions)	1,555	1,079	1,308	1,220
Net foreign assets of the banking system (US$ millions)	1,603	1,524	1,542	1,455
Excess reserves (percent of deposits)	33.1	16.2	19.4	5.9

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

1 Year ending July 7. Including commercial bank claims and liabilities to Eritrea.

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 5. Ethiopia: Balance of Payments, 2004/05–2012/13 [1]
(In millions of U.S. dollars, unless otherwise indicated)

	2004/05	2005/06	2006/07	2007/08 Staff Proj.	2008/09 Staff Proj.	2009/10 Staff Proj.	2010/11 Staff Proj.	2011/12 Staff Proj.	2012/13 Staff Proj.
Trade balance	-2,786	-3,592	-3,939	-4,723	-6,004	-6,611	-7,261	-7,906	-8,516
Exports of goods	847	1,001	1,187	1,461	1,656	1,812	2,018	2,237	2,497
Coffee	335	354	424	510	540	577	645	690	739
Horticulture	8	22	64	114	136	155	175		
Other	512	647	699	836	979	1,235	1,374	1,546	1,758
Imports of goods	3,633	4,593	5,126	6,183	7,660	8,423	9,280	10,143	11,014
Semi-Finished	665	822	766	1061					
Fuel	669	861	875	1,362	1,798	1,988	2,141	2,324	2,524
Capital goods	1,199	1,453	1,869	1,981	2,455	2,658	3,064	3,290	3,484
Cereals	160	195	161	175	180	185	190	195	200
Consumer Goods	986	1,282	1,317	1,346					
Nonfactor services (net)	277	149	161	245	399	562	685	1,084	1,416
Exports of nonfactor services	1,011	1,105	1,301	1,596	1,873	2,181	2,476	3,075	3,631
Imports of nonfactor services	734	955	1,140	1,352	1,474	1,619	1,790	1,991	2,216
Income (net)	-36	-38	13	-16	-25	-81	-123	-172	-183
Of which: gross official interest payments [2]	-51	-62	-36	-45	-52	-131	-192	-253	-283
Private transfers (net)	1,023	1,229	1,686	2,006	2,365	2,575	2,697	2,891	3,178
Current account balance, excl. official transfers	-1,522	-2,252	-2,080	-2,488	-3,265	-3,556	-4,002	-4,103	-4,106
(Percent of GDP)	-12.4	-14.8	-10.7	-10.1	-11.2	-11.2	-11.9	-11.4	-10.6
Excluding EAL imports	-11.2	-14.4	-10.5	-10.0	-10.4	-10.5	-11.2	-10.7	-10.0
Official transfers (net)	784	866	1,199	1,308	1,456	1,636	1,790	2,042	2,183
Current account balance, incl. official transfers	-738	-1,386	-881	-1,179	-1,809	-1,920	-2,212	-2,061	-1,923
(Percent of GDP)	-6.0	-9.1	-4.5	-4.8	-6.2	-6.1	-6.6	-5.7	-5.0
Excluding EAL imports	-4.9	-8.7	-4.3	-4.7	-5.4	-5.3	-5.9	-5.1	-4.4
Capital account balance (incl. errors and omissions)	670	1,070	875	1,093	2,168	2,337	2,442	2,416	2,539
Foreign direct investment (net)	150	365	482	627	642	825	1,011	1,078	1,198
Other investment (net)	459	163	195	466	1,525	1,512	1,431	1,338	1,341
Official long-term loans	271	80	239	466	1,525	1,512	1,431	1,338	1,341
Disbursements	344	343	345	539	1,595	1,649	1,643	1,662	1,749
Public Enterprises	125			168	752	747	747	747	747
Amortization [2]	73	263	106	73	69	137	213	324	408
Public Enterprises		41	40	51	47	115	184	286	351
Other public sector long-term loans (net)	193	-7	0	0	0	0	0	0	0
Other (net)	-6	90	-44	0	0	0	0	0	0
Errors and omissions	61	542	198	0	0	0	0	0	0
Overall balance	-68	-316	-6	-87	359	417	230	356	616
Financing	68	316	5	87	-359	-417	-230	-356	-616
Central bank (net; increase –)	-53	292	-38	87	-359	-417	-230	-356	-616
Reserves (increase –)	-204	397	-168	87	-359	-417	-230	-356	-616
Liabilities (increase +)	152	-104	130	0	0	0	0	0	0
Memorandum items:									
Exports of goods (percent change)	41.1	18.1	18.6	23.0	13.4	9.4	11.4	10.8	11.7
Export price index (percent change)	20.0	13.1	7.3	19.1	2.1	-1.4	1.0	1.0	1.0
Export volume index (percent change)	21.1	5.1	11.3	3.9	11.2	10.8	10.4	9.8	10.7
Imports of goods (percent change) [3]	40.4	29.5	12.4	20.9	20.6	10.3	10.5	9.5	8.8
Import price index (percent change)	11.8	8.3	9.1	13.5	12.6	2.0	1.0	1.0	1.0
Import volume index (percent change) [3]	28.6	21.2	3.3	7.5	8.0	8.3	9.5	8.5	7.8
Gross official reserves	1,555	1,158	1,326	1,239	1,599	2,015	2,245	2,601	3,218
(Months of imports of goods and nonfactor services of following year)	3.4	2.2	2.1	1.6	1.9	2.2	2.2	2.4	2.7
Terms of trade index, percent change (1996/97 = 100)	7.3	4.4	-1.7	5.0	-9.3	-3.3	0.0	0.0	0.0

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

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

2 For 2006/07, incorporates MDRI debt relief.

3 Excluding aircraft.

Table 6. Ethiopia: Millennium Development Goals

	1990	1995	2000	2005
Goal 1: Eradicate extreme poverty and hunger				
Income share held by lowest 20%	..	7.2	9.1	..
Malnutrition prevalence, weight for age (% of children under 5)	*47.7*	..	47.2	38.4
Poverty gap at $1 a day (PPP) (%)	..	8.0	4.8	..
Poverty headcount ratio at $1 a day (PPP) (% of population)	..	31.3	23.0	..
Poverty headcount ratio at national poverty line (% of population)	..	*45.5*	44.2	..
Prevalence of undernourishment (% of population)	..	69	..	*46*
Goal 2: Achieve universal primary education				
Literacy rate, youth total (% of people ages 15-24)	43	..	..	..
Persistence to grade 5, total (% of cohort)	*18*	..	..	..
Primary completion rate, total (% of relevant age group)	*26*	18	37	55
School enrollment, primary (% net)	*22*	..	36	61
Goal 3: Promote gender equality and empower women				
Proportion of seats held by women in national parliament (%)	..	*2*	2	21
Ratio of girls to boys in primary and secondary education (%)	*68*	..	65	76
Ratio of young literate females to males (% ages 15-24)	66	..	..	..
Share of women employed in the nonagricultural sector (% of total nonagricultural employmer	40.6	40.6	40.7	*40.6*
Goal 4: Reduce child mortality				
Immunization, measles (% of children ages 12-23 months)	38	38	52	59
Mortality rate, infant (per 1,000 live births)	122	107	92	80
Mortality rate, under-5 (per 1,000)	204	179	151	127
Goal 5: Improve maternal health				
Births attended by skilled health staff (% of total)	..	..	6	6
Maternal mortality ratio (modeled estimate, per 100,000 live births)	..	..	850	..
Goal 6: Combat HIV/AIDS, malaria, and other diseases				
Contraceptive prevalence (% of women ages 15-49)	4	..	8	15
Incidence of tuberculosis (per 100,000 people)	128	225	307	344
Prevalence of HIV, female (% ages 15-24)	..	..	..	..
Prevalence of HIV, total (% of population ages 15-49)	..	..	..	1.4
Tuberculosis cases detected under DOTS (%)	..	15	33	33
Goal 7: Ensure environmental sustainability				
CO2 emissions (metric tons per capita)	0.1	0.0	0.1	*0.1*
Forest area (% of land area)	14	..	14	13
GDP per unit of energy use (constant 2000 PPP $ per kg of oil equivalent)	2.6	2.4	2.7	*2.8*
Improved sanitation facilities (% of population with access)	3	..	..	*13*
Improved water source (% of population with access)	23	..	..	*22*
Nationally protected areas (% of total land area)	..	..	..	*18.6*
Goal 8: Develop a global partnership for development				
Aid per capita (current US$)	20	16	11	27
Debt service (PPG and IMF only, % of exports of G&S, excl. workers' remittances)	37.6	18.3	14.5	6.1
Fixed line and mobile phone subscribers (per 1,000 people)	2	3	4	14
Internet users (per 1,000 people)	..	0	0	2
Personal computers (per 1,000 people)	..	..	1	*3*
Total debt service (% of exports of goods, services and income)	39.0	18.4	12.9	4.1
Unemployment, youth female (% of female labor force ages 15-24)	..	..	..	11.2
Unemployment, youth male (% of male labor force ages 15-24)	..	..	..	4.1
Unemployment, youth total (% of total labor force ages 15-24)	..	..	..	7.7
Other				
Fertility rate, total (births per woman)	6.9	6.2	5.7	5.3
GNI per capita, Atlas method (current US$)	240	150	130	160
GNI, Atlas method (current US$) (billions)	12.1	8.3	8.1	11.1
Gross capital formation (% of GDP)	12.9	18.0	20.5	26.3
Life expectancy at birth, total (years)	45	44	42	43
Literacy rate, adult total (% of people ages 15 and above)	29	..	..	..
Population, total (millions)	51.2	56.5	64.3	71.3
Trade (% of GDP)	14.4	25.4	37.5	55.5

Source: World Development Indicators database

Note. Figures in italics refer to periods other than those specified.

Table 7. Ethiopia - Financial Soundness Indicators for the Banking Sector, 2003/04–2006/07

	2003/04	2004/05	2005/06	2006/07
Capital adequacy				
Capital to risk-weighted assets	11.7	11.5	11.4	20.4
Capital to assets	11.6	8.4	9.5	10.2
Asset composition and quality				
Total loans and advances to total assets	37.3	37.7	40.0	35.6
Sectoral distribution of loans to total loans				
Manufacturing	23.7	23.6	23.6	22.5
Construction	11.5	10.2	12.0	12.2
Agriculture	6.5	9.3	12.8	13.6
Transport	4.4	4.0	5.9	7.6
Hotel and tourism	1.8	1.5	1.2	2.2
Foreign exchange loans to total loans	-	-	-	
Gross nonperforming loans to gross loans	27.8	20.0	14.0	10.1
NPLs net of provisions to total capital	83.1	63.7	45.4	7.6
Large exposures to total capital	135.7	179.2	138.0	79.2
Earnings and profitability				
ROA	1.6	2.0	2.8	2.3
ROE	21.8	32.1	41.1	28.4
Interest margin to gross income	35.4	31.9	35.8	35.4
Noninterest expenses to gross income	41.1	28.7	31.6	33.5
Personnel expenses to noninterest expenses	30.3	42.6	43.1	43.8
Trading and fee income to total income	43.3	47.5	45.9	46.4
Interest rate earned on loans and advances	9.0	8.7	8.7	10.5
Interest rate paid on nonbank deposits	3.9	3.9	3.5	3.6
Spread (lending minus deposit rates)	5.1	4.8	5.2	6.9
Liquidity				
Liquid assets to total assets	52.7	47.3	44.6	40.4
Liquid assets to total short-term liabilities	82.1	77.9	71.1	75.2
Total loans to customer deposits	55.3	58.8	60.0	50.0
Foreign exchange liabilities to total liabilities	0.7	0.9	0.9	0.6

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

INTERNATIONAL MONETARY FUND

THE FEDERAL DEMOCRATIC REPUBLIC OF ETHIOPIA

Joint IMF/World Bank Debt Sustainability Analysis 2008

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

Approved by Martin Fetherston and Saul Lizondo (IMF) and
Sudhir Shetty and Carlos Braga (IDA)

July 1, 2008

This note assesses the sustainability of Ethiopia's external public debt and total public debt based on the joint World Bank-IMF debt sustainability framework for low-income countries.[1] *While external debt ratios have improved considerably with debt relief and public domestic debt in terms of GDP continues to decline, Ethiopia remains at moderate risk of debt distress.*

I. BACKGROUND

1. **The last DSA undertaken in May 2007 concluded that Ethiopia was at moderate risk of debt distress**.[2] Ethiopia reached its HIPC Initiative completion point in 2004 and benefited from debt relief under the MDRI in 2006. The debt relief provided under both initiatives helped to lower the debt ratio to less than 10 percent of GDP at end 2006/07.[3] [4]While the debt burden indicators were projected to remain below the policy dependent-thresholds for the whole projection period in the last DSA, it was projected that the indicative threshold for the NPV of debt-to-exports ratio would be breached under one stress test, leading to the assessment of moderate risk.

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[1] "Operational Framework for Debt Sustainability Assessments in Low-Income Countries – Further Considerations," IDA/R2005-0056 and http://www.imf.org/External/np/pp/eng/2005/032805.htm, 3/28/05.

[2] IMF Country Paper No.07/247, (July 2007).

[3] The Ethiopian fiscal year runs from July 8 to July 7.

[4] While Ethiopia has received debt relief from most of its creditors, it has not been able to reach agreement with Algeria, Libya, and FR Yugoslavia which account for over 17 percent of the debt stock in 2007/08.

2. **Despite continued strong export growth and an improved current account position, the revised DSA concludes that Ethiopia risk of debt distress remains moderate because of the large financing needs of the public enterprises over the next ten years.** Although the debt burden indicators remain below the policy dependent-thresholds for the whole projection period as in the last DSA, three stress tests breach the threshold for the NPV of debt to exports ratio when the debt stock is measured inclusive of public enterprises (public sector).[5]

II. MACROECONOMIC FRAMEWORK

3. **Except for growth prospects, the macroeconomic framework is slightly more favorable than the one presented in the last DSA.** Export growth in volume and value terms is stronger by 1 percentage point, but the trade balance is projected to deteriorate significantly on account of the rising oil import bill. Net FDI is comparable with the projection made a year ago while loan financing is projected to be higher by ½ percentage point of GDP per annum relative to the projection made a year ago.

[5] The World Bank Country Policy and Institutional Assessment (CPIA) classifies Ethiopia as a medium performer. The thresholds for the debt burden for medium performers are 150, 40 and 250 for the NPV of debt to exports, GDP and revenue respectively. Under the same classification, thresholds for debt service are 20 and 30 percent of exports and revenue, respectively.

Box 1. Macroeconomic Assumptions for the Baseline Scenario

Real GDP grows annually at about 7 percent until 2010/11, rising to 7½ percent thereafter. This assessment assumes continued good harvests supporting agriculture and increased activity in services and industry. **The inflation rate** is projected to decline to single digits within three years in response to tighter monetary and fiscal policies combined with the assumption that convergence of Ethiopia's commodity price index to the world price index is almost complete.

The fiscal deficit (including grants) is projected to decline to 2.5 percent of GDP in 2008/09 from 4.4 percent in 2007/08 in order to address the current macroeconomic imbalances and gradually increase toward 3.5 percent by 2014/15.

The current account deficit (before official transfers) is projected to remain fairly flat at about 10½ percent of GDP through 2012/13 with exports growing slightly faster than imports before improving to average out at 7 percent of GDP over the long term.

Exports of goods are projected to grow in volume at an annual rate of about 10½ percent between 2008/09 and 2012/13, led by pulses, leather products and flowers, with export prices projected to rise at an annual rate of ¾ percent. Over the long run export volume growth is projected to level out at 11½ percent per annum with export prices rising by 1 percent per annum.

Private transfers are assumed to dip slightly over the next few years and level out at 8 ¼ percent of GDP.

Foreign direct investment is envisaged to rise gradually over time from the current level of 2 ½ percent of GDP to slightly above 3 percent of GDP.

Official transfers are projected to average 5½ percent of GDP annually over the next five years, falling to 4½ percent in the long run. **Loan financing** on concessional terms is projected to average about 2 ¾ percent of GDP annually over the next five years but then decline sharply to about 1½ percent of GDP by 2026/27 because of the diminished need for external financing over the longer term. Loan financing for public enterprises at non-concessional rates is projected to average over 2 percent of GDP per annum over the same time period.

III. EXTERNAL DEBT SUSTAINABILITY ANALYSIS

A. Baseline

4. **In the baseline scenario, public and publicly guaranteed external debt remains under the various thresholds.** In particular, the NPV of debt to exports is projected to peak at 119 percent in 2013/14 as investments in the electricity and telecommunication sector reach their peak. This is an improvement over last year's profile for two reasons. First, the

lending profile for the public enterprises has shifted to the future in light of the difficulties of accessing large amounts of concessional financing quickly; this change lowers the NPV of debt. Second, export growth is now projected to be stronger, in light of improvements in export prices. The debt-to-GDP ratio has a similar hump-shaped profile, rising initially but falling over time to about 10 percent of GDP. Although the debt service ratio remains below the threshold of 20 percent of exports, it is projected to more than double over the next few years as a large fraction of new borrowing is for public enterprises on non-concessional terms.

5. **Under the historical scenario, the debt burden indicators are projected to reach higher levels than under the baseline scenario, but they do not breach the thresholds.** The NPV of debt to exports peaks at 124 percent in 2013/14 before dipping and settling at about 50 percentage points higher than in the baseline at the end of the forecast period. The profile of the NPV of debt to GDP ratio also deteriorates considerably over time to level out at 17 percent of GDP in 2026/27. The reason for the continued deterioration in the debt to GDP ratio using historical parameters is that the historical growth rate is slightly below the projection (about ½ percent per annum) and the historical borrowing needs are considerably higher than the projected needs over the 2016/17-2026/27 period.

B. Sensitivity Tests

6. **Three of the stress tests breach the indicative threshold for the NPV of debt to exports over the forecast horizon.** If new public sector loans are negotiated on less favorable terms (200 basis point higher interest rate during the forecast horizon), the debt ratio peaks at 166 percent in 2012/13, 16 percentage points above the debt sustainability threshold (Table 2, Figure 1).Also, if export growth is lower than the historical average by 1 standard deviation, the debt ratio breaches the threshold very soon and peaks at almost 216 percent in 2012/13. The scenario that applies one half standard deviation shocks to growth, exports and grants has similar features.

7. **The debt profile is highly sensitive to assumptions made about export growth in the long run although less sensitive to output growth prospects.** The baseline long-run forecast assumes that export growth of goods levels out at about 11 ½ percent per annum, with slightly higher growth for service exports on account of the expected foreign exchange proceeds from large infrastructure investments in the electricity, telecommunication, and transportation sectors. In a scenario with lower export growth (8 percent per annum over the forecast horizon) and lower output growth (5 percent per annum over the next five years compared to an average of 7 percent per annum in the baseline) the profile of the NPV of debt to exports would almost breach the indicative threshold in 2013/14. The debt profile in relation to output would not change much since the reduction in growth only lasts for five years and lower imports are reflected in higher reserve coverage rather than lower external borrowing (Figure 2). In an alternative scenario with export growth at 15 percent per annum,

closer to the growth rate projected by the authorities, the debt trajectory in terms of exports would be much more sustainable.

8. **Increased financing to ease the balance of payments constraint would only have a significant effect on debt sustainability if it were on nonconcessional terms.** As indicated in the 2008 IMF Article IV staff report, the petroleum bill for 2008/09 is about US$1 billion higher than in 2006/07 on account of the sharp rise in oil prices and the fast-growing economy. If additional financing of about US$1 billion were obtained on market terms to ease the balance of payments constraint, partly resulting from higher oil prices, it would raise the ratio of the NPV of debt to exports to considerably to 142 percent at its peak , compared with 119 percent under the baseline scenario. By contrast, if the financing were obtained on IDA terms, the ratio of the NPV of debt to exports is expected to reach 127 percent at its peak.

IV. FISCAL SUSTAINABILITY ANALYSIS

9. **Public domestic debt in terms of GDP continues to decline.** Despite significant borrowing by some public enterprises in 2007/08, domestic financing of the general government has been broadly in line with a relatively tight budget. Moreover, negative real interest rates on public debt resulting from rising inflation have also helped reduce the real debt burden. Consequently, domestic debt is projected to decline to 25 percent of GDP by end 2007/08, down by about 3 percentage points from a year ago.

10. **With the prospective increase in external debt, Ethiopia's public debt burden (including domestic debt) is expected to display a hump-shaped profile over the projected period**. The domestic debt profile is based on two assumptions: (i) domestic financing will gradually increase to 2½ percent of GDP per annum, and (ii) real domestic interest rates will gradually become positive. While rising in the short-run, the NPV of debt to GDP ratio is projected to decline from about 33 percent in 2013/14 to 28 percent over the long term (Figure 3). The NPV of debt to revenue ratio is projected to reach 185 percent by 2014/15 but to fall below 170 percent over the long term. Domestic financing of 3 percent of GDP, comparable to the outturn of 2006/07 would result in less favorable debt dynamics. The NPV of debt to GDP ratio would be close to 40 percent in 2013/14, before trending down. Moreover, if real interest rates became positive from 2008/09, without further fiscal tightening, the fiscal deficit would increase by 1–2 percentage points for the next few years and raise the NPV of debt to GDP ratio to 38 percent and the NPV of debt to revenue ratio to over 250 percent by 2013/14, before trending down to 220 percent in the long-term.

11. **Debt indicators would worsen under the lower growth scenario described above.** With real GDP growth assumed at 5 percent per annum for the next five years, the NPV of

debt-to-GDP ratio would climb up to 40 percent by 2013/14 and beyond, and the NPV of debt-to-revenue ratio would follow the similar path reaching 250 percent in 2026/27. This scenario highlights the importance of maintaining the growth momentum while continuing with adjustment efforts to correct the macroeconomic imbalances and avoid the debt stock following an unsustainable path. Delaying fiscal consolidation would significantly increase debt risks, as illustrated in the historical and bound tests.

V. CONCLUSION

12. **While external debt ratios have improved considerably with debt relief, and some of the debt indicators in the DSA have improved relative to last year on account of more rapid export growth, Ethiopia remains at moderate risk of debt distress.** This assessment illustrates the importance for Ethiopia to address its current macroeconomic imbalances so that it can maintain strong export and output growth. On the issue of debt, Ethiopia should secure grant and concessional financing, strengthen its debt management capacity, and develop a comprehensive debt strategy that includes public enterprises and contingent liabilities.

Table 1. Ethiopia: External Debt Sustainability Framework, Baseline Scenario, 2006/07-2026/27 1/
(In percent of GDP, unless otherwise indicated)

		Projections								
	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13	2016/17	2021/22	2026/27
External debt (nominal) 1/	**9.6**	**9.5**	**13.3**	**17.2**	**20.6**	**23.2**	**25.3**	**24.1**	**19.0**	**16.0**
o/w public and publicly guaranteed (PPG)	9.6	9.5	13.3	17.2	20.6	23.2	25.3	24.1	19.0	16.0
Change in external debt	-27.4	-0.1	3.8	3.9	3.4	2.7	2.0	-1.2	-0.8	-0.5
Identified net debt-creating flows	-1.2	1.6	3.5	2.7	2.4	1.3	0.2	-1.7	-1.4	-1.2
Non-interest current account deficit	**4.3**	**4.7**	**6.0**	**5.7**	**6.1**	**5.1**	**4.3**	**2.6**	**2.8**	**2.9**
Deficit in balance of goods and services	19.4	18.2	19.2	19.1	19.5	19.0	18.4	16.2	15.7	15.2
Exports	12.8	12.4	12.1	12.6	13.3	14.8	15.9	19.5	21.3	23.2
Imports	32.2	30.6	31.3	31.7	32.8	33.8	34.2	35.7	37.0	38.5
Net current transfers (negative = inflow)	-14.8	-13.5	-13.1	-13.3	-13.3	-13.7	-13.9	-13.3	-12.5	-11.8
Other current account flows (negative = net inflow)	-0.3	-0.1	-0.1	-0.1	-0.1	-0.1	-0.2	-0.4	-0.4	-0.5
Net FDI (negative = inflow)	**-2.5**	**-2.6**	**-2.2**	**-2.6**	**-3.0**	**-3.0**	**-3.1**	**-3.1**	**-3.1**	**-3.1**
Endogenous debt dynamics 2/	**-3.1**	**-0.5**	**-0.3**	**-0.5**	**-0.7**	**-0.9**	**-1.0**	**-1.1**	**-1.1**	**-1.0**
Contribution from nominal interest rate	0.2	0.1	0.2	0.3	0.5	0.6	0.7	0.6	0.2	0.1
Contribution from real GDP growth	-3.3	-0.6	-0.5	-0.8	-1.1	-1.4	-1.6	-1.7	-1.4	-1.1
Contribution from price and exchange rate changes	0.2	…	…	…	…	…	…	…	…	…
Residual (3-4) 3/	**-26.1**	**-1.7**	**0.2**	**1.2**	**1.0**	**1.4**	**1.8**	**0.5**	**0.6**	**0.6**
o/w exceptional financing	-23.4	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
NPV of external debt 4/	6.2	6.3	9.5	12.6	15.3	17.4	18.9	16.7	11.9	9.9
In percent of exports	48.6	50.9	78.8	100.2	114.8	117.5	119.1	85.7	55.7	42.7
NPV of PPG external debt	**6.2**	**6.3**	**9.5**	**12.6**	**15.3**	**17.4**	**18.9**	**16.7**	**11.9**	**9.9**
In percent of exports	48.6	50.9	78.8	100.2	114.8	117.5	119.1	85.7	55.7	42.7
Debt service-to-exports ratio (in percent)	3.7	2.9	3.1	5.8	8.0	9.6	10.6	9.7	4.8	2.7
PPG debt service-to-exports ratio (in percent)	3.7	2.9	3.1	5.8	8.0	9.6	10.6	9.7	4.8	2.7
Total gross financing need (billions of U.S. dollars)	0.5	0.6	1.2	1.2	1.4	1.3	1.1	0.7	0.6	0.6
Non-interest current account deficit that stabilizes debt ratio	31.7	4.7	2.3	1.8	2.7	2.5	2.3	3.8	3.6	3.5
Key macroeconomic assumptions										
Real GDP growth (in percent)	11.4	8.4	6.0	6.5	7.0	7.5	7.5	7.5	7.5	7.5
GDP deflator in US dollar terms (change in percent)	15.0	16.7	12.0	2.0	-0.7	-0.8	0.0	1.7	1.7	1.8
Effective interest rate (percent) 5/	0.6	1.6	2.1	2.7	3.0	3.1	3.1	2.6	1.3	1.0
Growth of exports of G&S (US dollar terms, in percent)	18.2	22.9	15.4	13.1	12.6	18.2	15.4	13.5	11.3	11.3
Growth of imports of G&S (US dollar terms, in percent)	12.9	20.2	21.2	9.9	10.2	9.6	9.0	10.1	10.2	10.3
Grant element of new public sector borrowing (in percent)	44.4	29.9	20.8	22.2	21.8	21.4	22.3	43.7	47.1	46.9
Memorandym item:										
Nominal GDP (billions of US dollars)	19.4	24.6	29.2	31.7	33.7	35.9	38.7	54.6	85.5	133.9

Source: Staff simulations.

1/ Includes both public and private sector external debt.

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

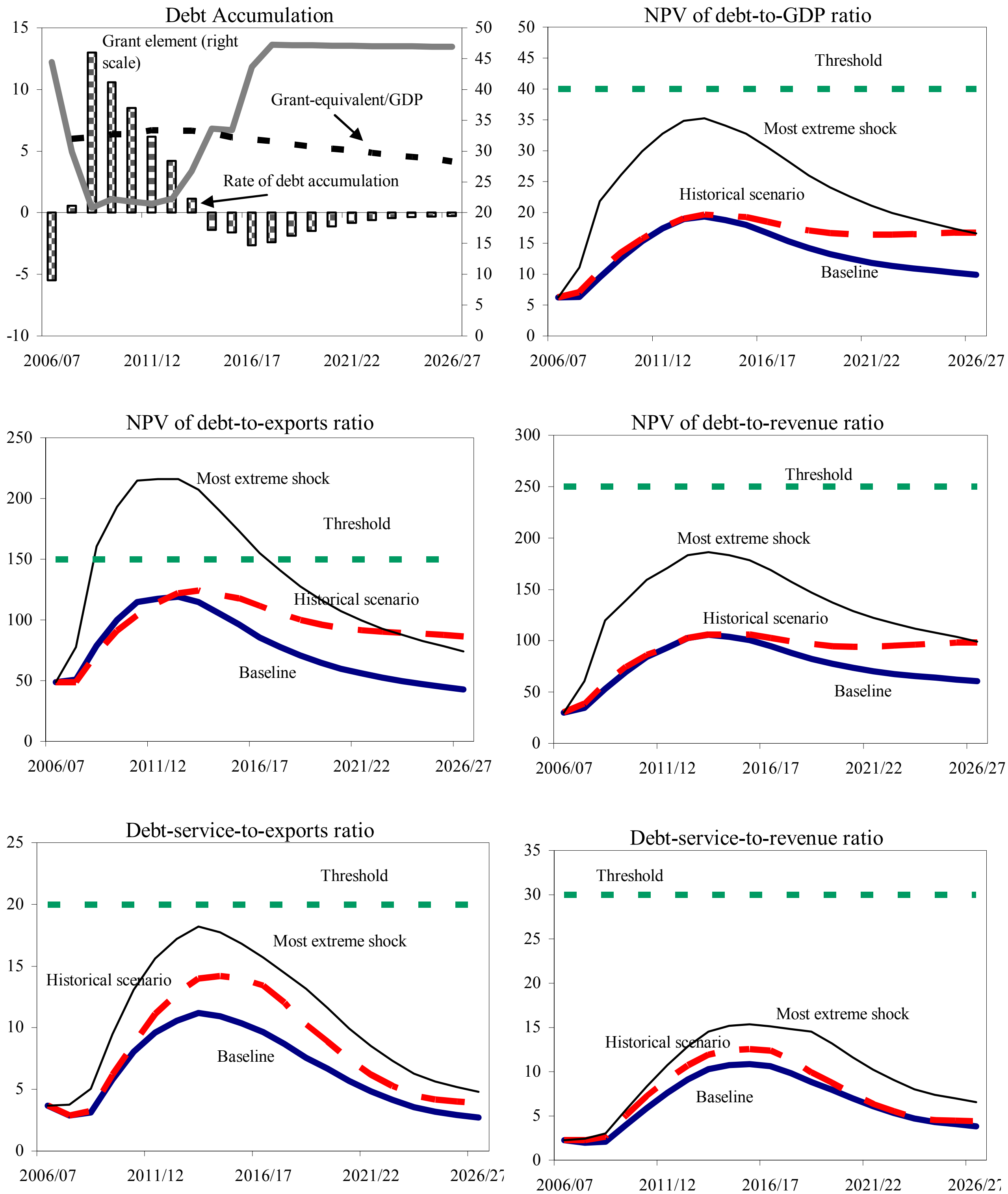
3/ Includes exceptional financing (i.e., changes in arrears and debt relief); changes in gross foreign assets; and valuation adjustments. For projections also includes contribution from price and exchange rate changes.

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

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

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

Figure 1. Ethiopia: Indicators of Public and Publicly Guaranteed External Debt
Under Alternative Scenarios, 2006/07-2026/27



Source: Staff projections and simulations.

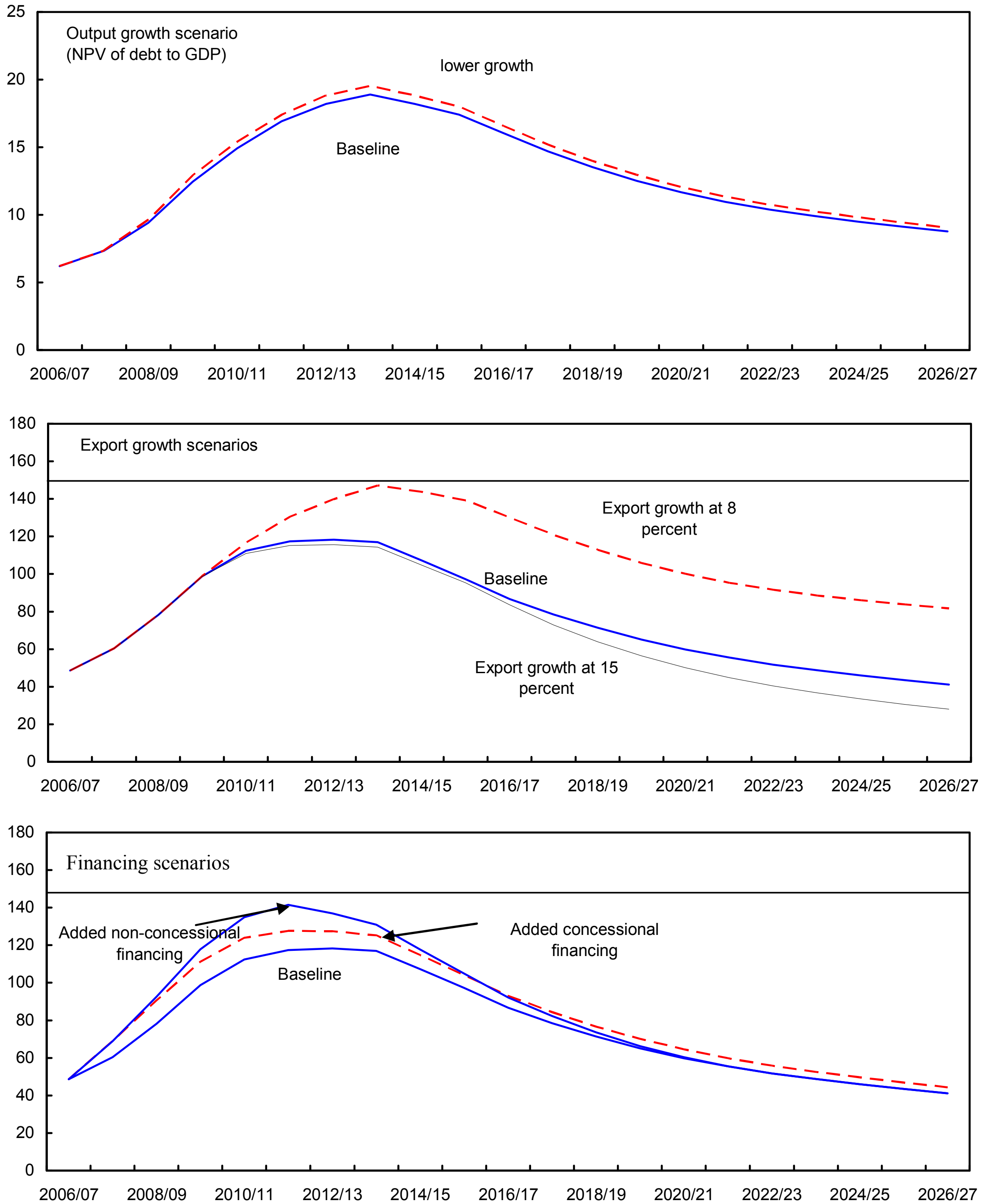
Table 2. Ethiopia: Sensitivity Analyses for Key Indicators of Public and Publicly Guaranteed External Debt, 2006/07-2026/27
(percent of GDP unless otherwise stated)

		Projections							
	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	2016/17	2021/22	2026/27
NPV of debt-to-GDP ratio									
Baseline	6.2	6.3	9.5	12.6	15.3	17.4	16.7	11.9	9.9
A. Alternative Scenarios									
A1. Key variables at their historical averages in 2007-26 1/	6.2	7.1	10.6	13.5	15.7	17.5	18.5	16.4	16.7
A2. New public sector loans on less favorable terms in 2007-26 2/	6.2	7.0	11.6	16.2	20.4	23.7	26.2	21.2	18.3
B. Bound Tests									
B1. Real GDP growth at historical average minus one standard deviation in 2007-08	6.2	6.8	10.9	14.5	17.5	19.9	19.1	13.6	11.4
B2. Export value growth at historical average minus one standard deviation in 2007-08 3/	6.2	7.3	11.9	14.9	17.6	19.6	18.6	13.0	10.6
B3. US dollar GDP deflator at historical average minus one standard deviation in 2007-08	6.2	7.8	14.0	18.6	22.6	25.6	24.6	17.5	14.6
B4. Net non-debt creating flows at historical average minus one standard deviation in 2007-08 4/	6.2	8.6	13.6	16.6	19.2	21.2	19.9	13.8	11.0
B5. Combination of B1-B4 using one-half standard deviation shocks	6.2	11.1	21.8	26.1	29.9	32.8	30.6	21.1	16.6
B6. One-time 30 percent nominal depreciation relative to the baseline in 2007 5/	6.2	8.5	12.8	17.0	20.6	23.4	22.4	16.0	13.4
NPV of debt-to-exports ratio									
Baseline	48.6	50.9	78.8	100.2	114.8	117.5	85.7	55.7	42.7
A. Alternative Scenarios									
A1. Key variables at their historical averages in 2007-26 1/	48.6	48.9	72.0	91.0	104.0	113.9	111.3	91.6	86.5
A2. New public sector loans on less favorable terms in 2007-26 2/	48.6	56.0	96.3	129.0	152.7	160.3	134.8	99.5	78.8
B. Bound Tests									
B1. Real GDP growth at historical average minus one standard deviation in 2007-08	48.6	50.9	78.8	100.2	114.8	117.5	85.7	55.7	42.7
B2. Export value growth at historical average minus one standard deviation in 2007-08 3/	48.6	77.4	160.5	193.0	214.7	216.0	155.2	99.5	74.0
B3. US dollar GDP deflator at historical average minus one standard deviation in 2007-08	48.6	50.9	78.8	100.2	114.8	117.5	85.7	55.7	42.7
B4. Net non-debt creating flows at historical average minus one standard deviation in 2007-08 4/	48.6	69.3	112.5	131.5	143.9	143.5	102.2	64.9	47.4
B5. Combination of B1-B4 using one-half standard deviation shocks	48.6	86.1	168.6	193.4	209.3	207.2	146.7	92.6	66.8
B6. One-time 30 percent nominal depreciation relative to the baseline in 2007 5/	48.6	50.9	78.8	100.2	114.8	117.5	85.7	55.7	42.7
Debt service ratio									
Baseline	3.7	2.9	3.1	5.8	8.0	9.6	9.7	4.8	2.7
A. Alternative Scenarios									
A1. Key variables at their historical averages in 2007-26 1/	3.7	2.9	3.2	6.2	8.7	11.1	13.4	6.2	3.9
A2. New public sector loans on less favorable terms in 2007-26 2/	3.7	2.9	2.9	4.8	6.5	7.4	11.1	8.2	6.1
B. Bound Tests									
B1. Real GDP growth at historical average minus one standard deviation in 2007-08	3.7	2.9	3.1	5.8	8.0	9.6	9.7	4.8	2.7
B2. Export value growth at historical average minus one standard deviation in 2007-08 3/	3.7	3.8	5.1	9.5	13.1	15.6	15.7	8.5	4.8
B3. US dollar GDP deflator at historical average minus one standard deviation in 2007-08	3.7	2.9	3.1	5.8	8.0	9.6	9.7	4.8	2.7
B4. Net non-debt creating flows at historical average minus one standard deviation in 2007-08 4/	3.7	2.9	3.1	5.8	8.1	9.6	9.7	5.5	3.1
B5. Combination of B1-B4 using one-half standard deviation shocks	3.7	3.5	4.2	7.9	11.0	13.1	13.1	7.8	4.4
B6. One-time 30 percent nominal depreciation relative to the baseline in 2007 5/	3.7	2.9	3.1	5.8	8.0	9.6	9.7	4.8	2.7
Memorandum item:									
Grant element assumed on residual financing (i.e., financing required above baseline) 6/	67	66.8	66.8	66.8	66.8	66.8	66.8	66.8	66.8

Source: Staff projections and simulations.

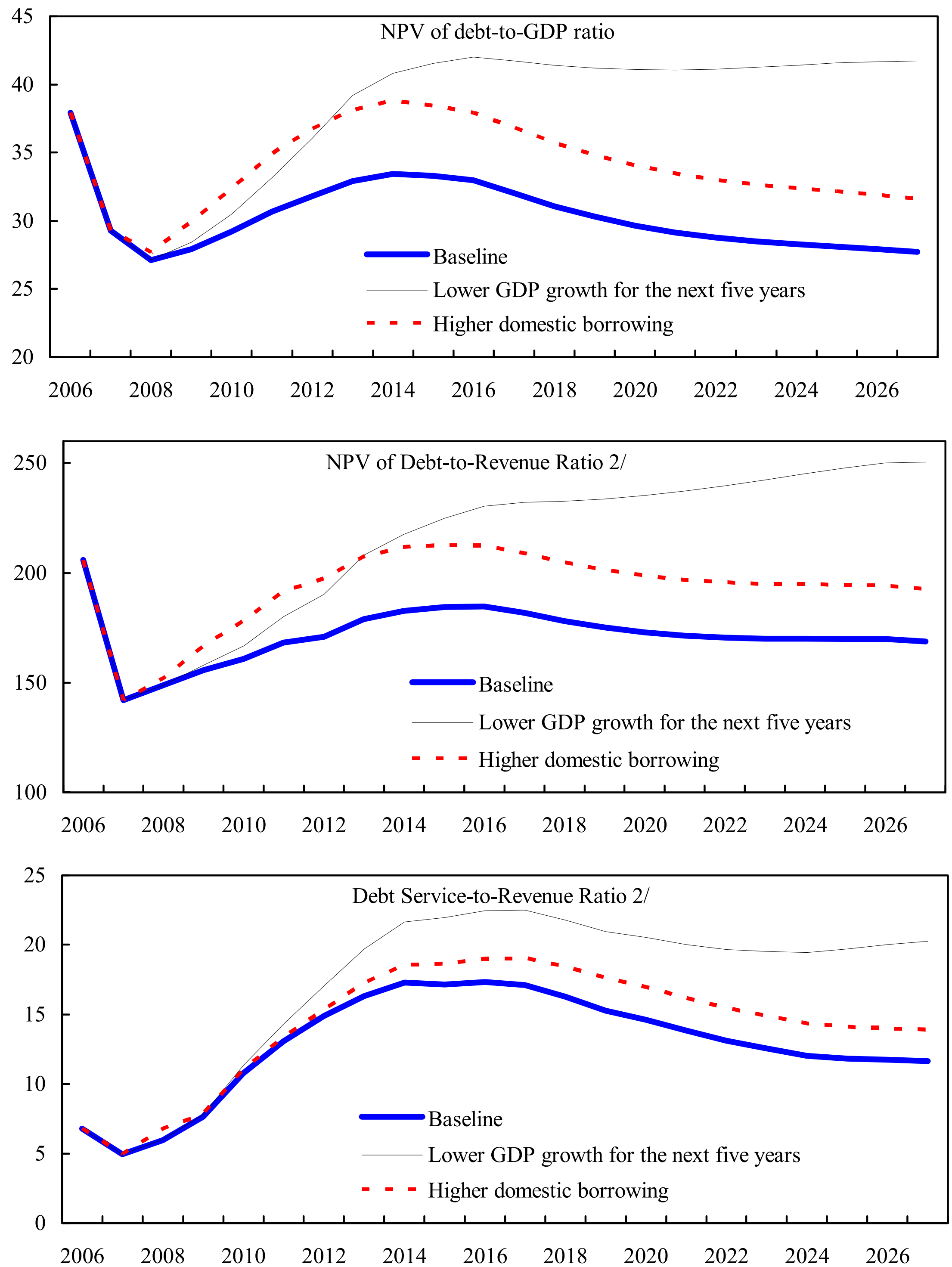
1/ Variables include real GDP growth, growth of GDP deflator (in U.S. dollar terms), non-interest current account in percent of GDP, and non-debt creating flows.
2/ Assumes that the interest rate on new borrowing is by 2 percentage points higher than in the baseline., while grace and maturity periods are the same as in the baseline.
3/ Exports values are assumed to remain permanently at the lower level, but the current account as a share of GDP is assumed to return to its baseline level after the shock (implicitly assuming an offsetting adjustment in import levels).
4/ Includes official and private transfers and FDI.
5/ Depreciation is defined as percentage decline in dollar/local currency rate, such that it never exceeds 100 percent.
6/ Applies to all stress scenarios except for A2 (less favorable financing) in which the terms on all new financing are as specified in footnote 2.

Figure 2. Ethiopia: Debt Sustainability Scenarios
(NPV of debt to exports, unless otherwise stated)



Source:IMF staff estimates

Figure 3.Country: Indicators of Public Debt Under Alternative Scenarios, 2006-2027 1/



Source: Staff projections and simulations.
1/ Most extreme stress test is test that yields highest ratio in 2016.
2/ Revenue including grants.

Table 3.Country: Public Sector Debt Sustainability Framework, Baseline Scenario, 2006/7-2026/27
(In percent of GDP, unless otherwise indicated)

	Act.	Projections								
	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13	2016/17	2021/22	2026/27
Public sector debt 1/	37.9	34.4	35.0	36.8	38.7	40.1	41.5	40.7	36.5	34.1
o/w foreign-currency denominated	9.6	9.5	13.3	17.2	20.6	23.2	25.3	24.1	19.0	16.0
Change in public sector debt	-29.8	-3.6	0.7	1.7	1.9	1.5	1.3	-1.0	-0.6	-0.5
Identified debt-creating flows	-10.9	-4.3	-3.6	-2.4	-1.5	-1.6	-1.6	-1.1	-0.7	-0.5
Primary deficit	3.6	4.6	2.2	0.9	0.8	0.7	0.9	1.7	1.9	1.9
Revenue and grants	20.6	18.2	17.9	18.2	18.2	18.6	18.4	17.6	16.9	16.4
of which : grants	6.8	4.2	4.2	4.3	4.5	4.9	4.8	4.3	3.7	3.3
Primary (noninterest) expenditure	24.2	22.8	20.2	19.1	19.0	19.3	19.3	19.3	18.8	18.3
Automatic debt dynamics	-13.9	-8.3	-5.8	-3.2	-2.3	-2.3	-2.6	-2.8	-2.7	-2.5
Contribution from interest rate/growth differential	-10.4	-7.2	-5.1	-3.3	-2.9	-3.0	-3.0	-2.9	-2.6	-2.3
of which : contribution from average real interest rate	-3.4	-4.3	-3.2	-1.2	-0.5	-0.3	-0.2	0.0	0.0	0.1
of which : contribution from real GDP growth	-7.0	-2.9	-2.0	-2.2	-2.4	-2.7	-2.8	-2.9	-2.6	-2.4
Contribution from real exchange rate depreciation	-3.5	-1.1	-0.7	0.1	0.6	0.7	0.4	0.2	-0.1	-0.1
Other identified debt-creating flows	-0.6	-0.5	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Debt relief (HIPC and other)	-0.6	-0.4	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Residual, including asset changes	-18.9	0.7	4.3	4.1	3.4	3.1	3.0	0.1	0.1	0.1
NPV of public sector debt	29.3	27.1	27.9	29.2	30.7	31.8	32.9	32.0	28.8	27.7
o/w external	0.9	2.3	6.2	9.6	12.6	14.9	16.7	15.4	11.2	9.6
Gross financing need 2/	4.6	5.7	3.6	2.9	3.2	3.5	3.9	4.7	4.1	3.8
NPV of public sector debt-to-revenue ratio (in percent) 3/	142.0	148.8	155.8	160.7	168.3	170.8	178.9	181.8	170.4	168.7
o/w external	4.4	12.4	34.5	52.9	69.0	80.2	90.8	87.6	66.3	58.5
Debt service-to-revenue ratio (in percent) 3/ 4/	5.0	6.0	7.6	10.8	13.1	14.9	16.3	17.1	13.1	11.6
Primary deficit that stabilizes the debt-to-GDP ratio	33.4	8.1	1.6	-0.8	-1.1	-0.8	-0.4	2.7	2.5	2.4
Key macroeconomic and fiscal assumptions										
Real GDP growth (in percent)	11.4	8.4	6.0	6.5	7.0	7.5	7.5	7.5	7.5	7.5
Average nominal interest rate on forex debt (in percent)	0.6	1.7	2.3	3.0	3.3	3.4	3.4	2.7	1.4	1.0
Average real interest rate on domestic currency debt (in percent)	-12.4	-16.4	-13.6	-5.8	-2.8	-2.2	-1.6	-0.4	0.1	0.4
Inflation rate (GDP deflator, in percent)	16.8	23.4	21.2	12.3	9.3	9.3	9.1	7.7	7.7	7.7
Growth of real primary spending (deflated by GDP deflator, in percent)	25.0	2.3	-6.0	0.7	6.4	9.1	7.6	6.7	6.7	7.2
Grant element of new external borrowing (in percent)	44.4	29.9	20.8	22.2	21.8	21.4	22.3	43.7	47.1	46.9

Sources: Ethiopian authorities; and Fund staff estimates and projections.
1/ Covering public and publicly guaranteed debt on gross basis.
2/ Gross financing need is defined as the primary deficit plus debt service plus the stock of short-term debt at the end of the last period.
3/ Revenues including grants.
4/ Debt service is defined as the sum of interest and amortization of medium and long-term debt.

Table 4. Ethiopia: Sensiticity Analysis for Key Indicators of Public Debt; 2006/07-2026/27

	Act.	Projections								
	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13	2016/17	2021/22	2026/27
NPV of Debt-to-GDP Ratio										
Baseline	29	27	28	29	31	32	33	32	29	28
A. Alternative scenarios										
A1. Real GDP growth and primary balance are at historical averages	29	27	29	32	36	40	43	49	50	53
A2. The government's net fomestic borrowing is at 3 percent of GDP. 1/	29	28	30	32	35	37	38	37	33	32
A3. Lower GDP growth for the next five years 2/	29	27	28	30	33	36	39	42	41	42
B. Bound tests										
B1. Real GDP growth is at historical average minus one standard deviations in 2008/09-2009/10	29.3	27	30	35	38	41	44	47	47	48
B2. Primary balance is at historical average minus one standard deviations in 2008/09-2009/10	29.3	27	31	36	37	38	39	37	32	29
B3. Combination of B1-B2 using one half standard deviation shocks	29.3	27	31	36	37	38	38	35	29	26
B4. One-time 30 percent real depreciation in 2008/09	29.3	27	29	30	31	33	34	34	30	28
NPV of Debt-to-Revenue Ratio 3/										
Baseline	142	149	156	161	168	171	179	182	170	169
A. Alternative scenarios										
A1. Real GDP growth and primary balance are at historical averages	142	148	160	177	197	213	234	272	289	308
A2. The government's net fomestic borrowing is at 3 percent of GDP. 1/	142	152	167	178	192	197	207	209	196	193
A3. Lower GDP growth for the next five years 2/	142	149	158	167	180	190	208	232	240	251
B. Bound tests										
B1. Real GDP growth is at historical average minus one standard deviations in 2008/09-2009/10	142	149	167	189	205	215	231	260	273	287
B2. Primary balance is at historical average minus one standard deviations in 2008/09-2009/10	142	149	171	197	203	204	212	209	188	174
B3. Combination of B1-B2 using one half standard deviation shocks	142	149	169	194	200	200	206	199	172	155
B4. One-time 30 percent real depreciation in 2008/09	142	149	160	164	173	177	187	194	181	172
Debt Service-to-Revenue Ratio 3/										
Baseline	5	6	8	11	13	15	16	17	13	12
A. Alternative scenarios										
A1. Real GDP growth and primary balance are at historical averages	5	6	5	12	18	21	24	26	24	27
A2. The government's net fomestic borrowing is at 3 percent of GDP. 1/	5	7	8	11	13	15	17	19	15	14
A3. Lower GDP growth for the next five years 2/	5	6	8	11	14	17	20	22	20	20
B. Bound tests										
B1. Real GDP growth is at historical average minus one standard deviations in 2008/09-2009/10	5	6	8	13	18	21	23	25	23	25
B2. Primary balance is at historical average minus one standard deviations in 2008/09-2009/10	5	6	8	16	23	19	19	18	16	13
B3. Combination of B1-B2 using one half standard deviation shocks	5	6	8	15	21	18	18	17	14	10
B4. One-time 30 percent real depreciation in 2008/09	5	6	8	12	15	17	19	20	14	12

Sources: Ethiopian authorities; and Fund staff estimates and projections.
1/ Assumes that the government's net domestic borrowing stays at 3 percent of GDP during 2007/08-2026/27.
2/ Assumes the GDP growth at five percent during 2009-2014, with the same amount of public sector borrowing as assumed under Baseline scenario.
3/ Revenues are defined inclusive of grants.

INTERNATIONAL MONETARY FUND

THE FEDERAL DEMOCRATIC REPUBLIC OF ETHIOPIA

Staff Report for the 2008 Article IV Consultation—Informational Annex

Prepared by the African Department

(In consultation with other departments)

Approved by Saul Lizondo and Martin Fetherston

July 1, 2008

Page

ANNEX I. Ethiopia: Relations with the Fund
(As of April 30, 2008)

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

II. General Resources Account:	**SDR Million**	**%Quota**
Quota	133.70	100.00
Fund holdings of currency	126.31	94.47
Reserve position	7.44	5.57
Holdings exchange rate		

III. SDR Department:	**SDR Million**	**%Allocation**
Net cumulative allocation	11.16	100.00
Holdings	0.19	1.74

IV. Outstanding Purchases and Loans: None

V. Latest Financial Arrangements:

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

VI. Projected Payments to Fund
(SDR millions; based on current use of resources and present holdings of SDRs):

	Forthcoming				
	2008	2009	2010	2011	2012
Principal	0.00	0.00	0.00	0.00	0.00
Charges/interest	0.23	0.30	0.30	0.30	0.30
Total	0.23	0.30	0.30	0.30	0.30

VII. Implementation of HIPC Initiative:

1. Commitment of HIPC assistance	Enhanced Framework
Decision point date	Nov. 2001
Assistance committed by all creditors (US$ millions) [1]	1,982.20
Of which: IMF assistance (US$ millions)	60.85
(SDR equivalent in millions)	45.12
Completion point date	Apr 2004

2. Disbursement of IMF assistance (SDR millions)	
Assistance disbursed to the member	45.12
Interim assistance	10.28
Completion point balance	34.84
Additional disbursement of interest income [2]	1.54
Total disbursements	46.66

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

1. MDRI-eligible debt (SDR million) [3]	112.07
Financed by: MDRI Trust	79.66
Remaining HIPC resources	32.41

2. Debt relief by facility (SDR millions)

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

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

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

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

IX. Safeguards Assessment

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

X. Exchange Rate Arrangement

The de facto exchange rate regime is classified as a crawling peg, in light of the recent market developments. The authorities describe the de jure exchange rate regime as a managed float with no predetermined path for the exchange rate, and the Birr has steadily depreciated against the U.S. dollar. The pace of the depreciation, however, has been stable. Furthermore, the NBE supplies foreign exchange to the market based on plans established at the beginning of each fiscal year that took into account estimates of likely supply and demand. The transaction-weighted average interbank market exchange rate on May 30, 2008, was Br 9.5697 = US$1.

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

XI. Article IV Consultation

Ethiopia is on the standard 12-month consultation cycle. The Executive Board concluded the last Article IV consultation on June 2, 2007 (IMF Country Report No.06/159, May 2006; www.imf.org).

XII. Technical Assistance (2002—present)

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

FAD	Tax and customs administration reforms	June–July 2003
STA	Reconciliation of fiscal and monetary accounts	August 2003
MFD	Monetary operations	October 2003
MFD	Plan for restructuring the CBE	November 2003
STA	Monetary and financial statistics mission	January–February 2004
STA	Balance of payments statistics	April 2004
MFD	Payments system	May 2004
MFD	Bank supervision	July 2004
STA	Monetary and financial statistics	September 2004
STA	Producer price index	October 2004
FAD	Modernization of tax administration	November 2004
FAD	Program/performance budgeting	January–February 2005
STA	Balance of payments statistics	January–February 2005
MFD	Bank supervision	June–July 2005
STA	Balance of payments statistics	July 2005
STA	Government finance statistics	August 2005
FAD	Tax administration	September 2005
MCM	Bank supervision	February 2006
MCM	Modernization of payment systems	March 2006
STA	Consumer price data	March 2006
FAD	Tax policy assessment	May 2006
MCM	Bank supervision	July 2007
MCM	Monetary operations	July 2007
MCM	Payment system	July 2007
AFE	Customs Administration	October 2007
FAD	Public expenditure management	December 2007
AFE	Macro-fiscal	January 2008
AFE	Program budgeting	January 2008
AFE	Banking Supervision	February 2008
AFE	Consumer price index	March 2008

XIII. Resident Representative

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

ANNEX II. Ethiopia—Joint World Bank-Fund Work Program —May 2008–April 2009

Title	Products	Provisional timing of missions	Expected delivery date
A. Mutual information on relevant work programs			
The World Bank work program in the next 12 months	**Macro and Fiscal Policy Analysis:** • Annual Public Finance Review	Jul. 2008–Jun. 2009	Q1 2009
	Analysis of growth and private sector development: • Regional Growth Report (Addis Ababa) • Policy advice on privatization, WTO accession, Implementation of the revised Competition law, and export capacity development	Apr 2008–Dec 2008 Sep./Oct. 2008	Q4 2008 Q2 2009
	Technical Assistance: • Support to develop National Strategy for the Development of Statistics • To improve the Household Income, Consumption and Expenditure data collection methodology • To strengthen the capacity of the public sector • Financial Sector Capacity Building Project		Q4 2008 Q4 2009 Q4 09, extension expected Extension expected
The Fund work program in the next 12 months	**Macroeconomic policy analysis and advice**	May 2008 (Article IV) November 2008 (staff visit)	July 2008 (Staff Report, Selected Issues Paper)
	Technical assistance • Revenue administration and tax reform • Public financial management • Regulatory framework for financial sector • Statistical capacity (government finance, national accounts, monetary/financial statistics, CPI)	Jun./Jul. 2008 Sep. 2008–Mar. 2009 Jul. 2008–Jan. 2009 June 2008–April 2009	
B. Requests for work program inputs			
Fund request to Bank	• Periodic update on progress • Update on FSCBP		
Bank request to Fund	• Regular update of macro projections till 2012/13		Following the Article IV missions
C. Agreement on joint products and missions			
Joint products in the next 12 months	• Debt Sustainability Analysis • Assisting the authorities with their financial sector strategy.		• July/August 2008

ANNEX III. **Ethiopia: Statistical Issues**

General

1. Data provided to the Fund are adequate for surveillance purposes, but there are shortcomings in real, fiscal, and balance of payments statistics. Ethiopia participates in the General Data Dissemination System (GDDS) and metadata were partially updated in early 2008. Ethiopia participates in the GDDS project for capacity building in statistics in Anglophone Africa (2006—2009) including macro-economic and financial statistics and socio-demographic statistics

2. The authorities have prepared and will soon publish the Statistical Appendix for the 2008 Article IV Consultations, as part of the pilot project launched by the African Department of the IMF. The 2007 Statistical Appendix is posted on the National Bank of Ethiopia (NBE) website (http://www.nbe.gov.et/).

Real sector

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

Public finances

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

(annual) as well as the budgetary central government (monthly) on a cash basis in conformity with the methodology of the *GFSM 2001* by April 2009.

Monetary accounts

5. Two STA technical assistance missions in 2004 found that the quality of monetary and financial statistics was compromised by methodological problems. The missions recommended correcting certain misclassifications of accounting data, helped the central bank compile standardized report forms (SRFs) for reporting monetary statistics to STA, and worked with the authorities and AFR to establish an integrated monetary database (IMD). The follow-up mission in September 2004 finalized the IMD. The authorities then provided SRF-based data for the NBE and other depository corporations to STA until December 2004. At present, there is a need for the NBE to resume data submissions based on the SRF and IMD framework. A technical assistance mission in FY2009 will assist the NBE to resume reporting SRF-based monetary data to the IMF.

Balance of payments

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

Social indicators

7. Data on poverty are derived from household surveys regularly conducted by the Central Statistical Authority.[1] The government, with assistance from the World Bank, has constructed indicators for measuring poverty reduction, including income and expenditure per capita, income inequality, literacy, malnutrition, and infant/child mortality.
During 2004/05 the authorities conducted a number of surveys to measure household welfare, including (i) a participatory poverty assessment; (ii) the Household Income, Consumption and Expenditure Survey (HICES); and (iii) a welfare monitoring survey. The data are currently being processed. There is no adequate data on prevalence rates of HIV/AIDS, especially among the rural population, and it is not clear whether food consumption among people living in drought-prone areas is properly monitored. The welfare monitoring survey conducted in 2004/05 is expected to produce indicators relating to HIV/AIDS.

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

ANNEX IV. ETHIOPIA: TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE
(As of June 23, 2008)

	Date of Latest Observation	Date Received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of Publication[6]
Exchange rates	April 8, 2008	April 9, 2008	D	D	D
International reserve assets and reserve liabilities of the monetary authorities[1]	April 2008	June 2008	M	M	M
Reserve/base money	April 2008	June 2008	M	M	M
Broad money	April 2008	June 2008	M	M	M
Central bank balance sheet	April 2008	June 2008	M	M	M
Consolidated balance sheet of the banking system	April 2008	June 2008	M	M	M
Interest rates[2]	March 2008	May 2008	M	M	M
Consumer Price Index	May 2008	June 2008	M	M	M
Revenue, expenditure, balance, and composition of financing[3] – general government[4]	March 2008	May 2008	Q	Q	Q
Revenue, expenditure, balance, and composition of financing[3] – central government	March 2008	May 2008	Q	Q	Q
Central government and central government-guaranteed debt[5]	2006/07	November 2007	A	On Mission	A
External current account balance	December 2007	February 2008	Q	Q	Q
Exports and imports of goods and services	December 2007	February 2008	Q	Q	Q
GDP/GNP	2006/07	November 2007	A	On Mission	A
Gross external debt	2006/07	November 2007	A	On Mission	A

1Includes reserve assets pledged or otherwise encumbered and net derivative positions.
2 Both market-based and officially determined, including discount rates, money market rates, and rates on treasury bills, notes, and bonds.
3 Foreign, domestic bank, and domestic nonbank financing.
4 The general government consists of the central government (budgetary funds, extrabudgetary funds, and social security funds) and state and local governments.
5 Including currency and maturity composition.
6 Daily (D), weekly (W), monthly (M), quarterly (Q), annually (A).

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International Monetary Fund
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IMF Concludes 2008 Article IV Consultation with The Federal Democratic Republic of Ethiopia

On July 14, 2008, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with The Federal Democratic Republic of Ethiopia.[1]

Background

The Ethiopian economy has been growing rapidly in the last four years. Favorable weather conditions and pro-growth policies have helped sustain recovery from a sharp drought-related contraction in 2002/03 (fiscal year begins July 8). Growth has averaged 11 percent since 2003/04, far exceeding the minimum growth target of 7 percent in the Program for Accelerated and Sustainable Development (PASDEP) that is estimated to be consistent with keeping the Millennium Development Goals (MDGs) within reach. In recent years, however, it has become clear that demand is running ahead of the expansion in the capacity of the economy. Inflation was almost 40 percent on a 12-month basis in May 2008, and international reserves have fallen to 1.5 months of imports. Inflation is being driven largely by rapidly rising domestic food prices.

Domestic public sector borrowing has been at a high level in the last two years in part because of heavy public enterprise expenditure. Helped by some revenue measures and increased external financing and privatization revenues, domestic financing of the general government is being contained below the 2.5 percent of GDP budget target in 2007/08. But with significant borrowing by public enterprises, IMF staff estimate that the overall domestic public sector borrowing will remain at about 5 percent of GDP.

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

Broad money growth remains high. The National Bank of Ethiopia (NBE) raised minimum reserve requirements on commercial bank deposits and the minimum interest rates on time and saving deposits in July 2007 and April 2008. This has helped reduce banks' excess reserves. But broad money growth has stayed high due to credit expansion to public enterprises and the financing of the general government deficit.

The rise in world oil prices has significantly added to pressures on international reserves. Surging coffee prices have helped to limit the impact on the terms of trade, and private remittances have risen sharply. However, IMF staff estimate that a full-year impact of higher oil prices will raise Ethiopia's oil import bill by about $1 billion (over 3 percent of GDP) over its 2006/07 level. High oil prices were only partially passed through to consumers, with higher costs being absorbed by the Oil Stabilization Fund. The official exchange rate for the Birr against the U.S. dollar (the intervention currency) has continued to depreciate and reached Birr 9.6 per U.S. dollar at end-May 2008.

IMF staff project that real GDP growth will slow to 8.4 percent in 2007/08. Inflation is projected to be about 30 percent at the end of 2007/08 on a 12-month basis.

Executive Board Assessment

Executive Directors welcomed Ethiopia's stronger and more diversified economic growth of recent years, which has enabled the country to keep the Millennium Development Goals within reach. Directors cautioned, however, that the recent signs of growing macroeconomic imbalances manifested as higher inflation and a weakening of the balance of payments suggest that demand is running ahead of capacity expansion. They noted that some supply-side factors may also have driven up food prices and thereby contributed to inflationary pressures. At the same time, the surge in world oil prices is placing a large strain on the balance of payments.

Against this background, Directors welcomed the authorities' intention to address the macroeconomic imbalances and to absorb the world oil price shock in a manner that least affects the momentum for growth and poverty reduction. They commended the authorities' recent strengthening of policy coordination and their objective of slowing monetary growth and reducing public sector borrowing. Directors emphasized that the authorities' efforts should be supported by continued structural reforms to encourage private sector development and make the economy more resilient to shocks.

Directors stressed that forceful policy tightening will be needed in the period ahead to reduce inflation and ensure that inflation expectations do not become ingrained. The measures introduced to date to mop up excess reserves in the banking system will need to be complemented by strict limits on central bank advances to the government. Directors therefore welcomed the authorities' readiness to monitor developments closely and to tighten monetary policy further as needed.

Directors underscored that determined fiscal restraint, anchored in a significant reduction in public sector domestic borrowing, will be crucial to the authorities' adjustment efforts. They accordingly considered appropriate the authorities' intention to contain the government's domestic borrowing well below last year's level. Given the importance of public infrastructure investment, a tighter fiscal stance will require capital expenditure to be aimed at projects that enhance productivity and contribute most to economic growth. Restraint on domestic borrowing by public enterprises will be essential.

Directors stressed that continuing pass through of world oil prices to consumers will be needed to facilitate an adjustment to the oil price shock and to alleviate growing strains on the Oil Stabilization Fund. However, they acknowledged that determining the appropriate pace and timing of pass through will be challenging in the context of the current high inflation, the impact on specific sectors, and social and political feasibility.

Directors recognized the risk that the necessary policy tightening could slow growth and set back efforts to reduce poverty. They accordingly urged the authorities to carefully prioritize budget spending to protect the most vulnerable members of society. Directors also encouraged the authorities to seek additional foreign assistance to support their adjustment efforts and complement their plans to protect pro-poor spending and investment in capital projects. Grants or highly concessional financing should be sought to preserve external debt sustainability. In this context, Directors recommended that a comprehensive public debt strategy should be prepared, incorporating public enterprise debt and contingent liabilities.

In light of the fragility of the balance of payments, Directors welcomed the recent increase in exchange rate flexibility, and encouraged the authorities to foster a deeper and more competitive foreign exchange market. While noting staff's assessment that there is no clear evidence of exchange rate overvaluation, Directors nevertheless welcomed the authorities' intention to keep external competitiveness under review. Over time, sustained robust export growth will require the authorities to carry forward vigorously their structural reform agenda aimed at raising productivity and improving business conditions. Directors welcomed the authorities' intentions in this area.

Directors stressed that increasing competition in the banking sector is central to improving the environment for implementing monetary policy and encouraging private sector development. This could be facilitated by exploring partnerships with foreign financial institutions. More generally, Directors encouraged the authorities to step up banking reforms and to strengthen banking supervision.

Directors underscored the importance of reforms that ensure that the public sector contributes effectively to the development of the Ethiopian economy. They encouraged the authorities to complete their consideration of tax reforms and to implement measures rapidly to reverse the declining tax-to-GDP ratio. Measures to further strengthen public expenditure management, including through the introduction of performance budgeting, will be needed to improve the quality and efficiency of public spending.

Directors considered that the data provided to the Fund are adequate for surveillance purposes, but further steps should be taken to address shortcomings in several areas.

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

Ethiopia: Selected Economic and Financial Indicators, 2005/06-2007/08 [1]			
	2005/06	2006/07	2007/08
			Est.
			(Annual percentage change)
National income and prices			
GDP at constant prices (at factor cost)	11.6	11.4	8.4
Consumer prices (period average)	12.3	15.8	22.4
Consumer prices (end period)	10.8	15.1	30.8
External sector			
Exports, (In U.S. dollars, f.o.b.)	18.1	18.6	23.0
Imports, (In U.S. dollars, c.i.f.)	29.5	12.4	20.9
Export volume	5.1	11.3	3.9
Import volume	21.2	3.3	7.5
Terms of trade (deterioration –)	4.4	-1.7	5.0
			(Annual percentage change, unless otherwise indicated)
Money and credit			
Net foreign assets	-4.6	5.1	0.5
Net domestic assets	28.9	25.4	28.2
Net claims on the government	12.5	16.3	18.5
Net claims on public enterprises	33.0	36.7	46.0
Net claims on private sector	28.3	27.3	26.3
Broad money	17.4	19.7	21.4
Velocity (GDP/broad money)	2.77	3.01	3.32
			(In percent of GDP, unless otherwise indicated)
Financial balances			
Gross domestic saving	3.7	5.6	4.1
Government saving	2.7	1.3	1.0
Private saving	0.9	4.4	3.1
Gross domestic investment	24.2	25.0	21.9
Public investment	16.7	18.2	15.6
Private investment	7.6	6.7	6.3
Resource gap	-20.6	-19.3	-18.2
External current account balance, including official transfers	-9.1	-4.5	-4.8
Government finances			
Revenue	14.8	12.8	13.1
External grants	3.6	5.0	4.2
Expenditure and net lending	22.3	20.8	21.7
Fiscal balance, excluding grants (cash basis)	-7.4	-8.1	-8.6
Fiscal balance, including grants (cash basis)	-3.9	-3.1	-4.4
Total financing (excluding residual)	2.5	4.3	4.4
External financing	1.1	1.1	1.5

Domestic financing (not including privatization)	1.3	3.1	2.4
Public debt [3]	68.1	37.9	34.4
Domestic debt [2]	30.9	28.4	24.9
External debt (including to Fund)	37.3	9.6	9.5
Net present value (NPV) of external debt-to-exports ratio (including to Fund) [3]	50.8	48.6	50.9
External debt-service ratio [4]	5.0	0.7	0.4
Overall balance of payments (in millions of U.S. dollars)	-316	-6	-56
Gross official reserves (in millions of U.S. dollars)	1,158	1,326	1,239
(in months of imports of goods and nonfactor services of following year)	2.2	2.1	1.6
GDP at current market prices (in millions of birr)	131,672	170,921	229,229

Sources: Ethiopian authorities; and IMF staff estimates and projections.
1. Except for data on external sector which is based on July 1-June 30, data pertain to the period July 8-July 7.
2. Whole series was revised
3. Including debt to major public enterprises.
4. After enhanced HIPC and MDRI relief.

Statement by Mr. Peter Gakunu, Executive Director
for The Federal Democratic Republic of Ethiopia
and Mr. Ebson Uanguta, Advisor to Executive Director

July 14, 2008

1. The Ethiopian authorities appreciate the candid and open discussion with staff during the recent 2008 Article IV consultation. They value the timely and useful contributions of the mission team to key policy issues aimed at supporting the implementation of the Plan for Accelerated and Sustainable Development to End Poverty (PASDEP), while addressing the current imbalances. They find the staff assessment of the country's economic policies, challenges and prospects as informative, fair and well balanced.

Recent economic developments

2. The authorities' pro-growth policies have been highly successful in recent years. Real GDP growth has averaged 11.8 percent annually over the last four years, which has been the highest among all non-oil producing countries in Africa. This period has also witnessed the beginnings of two peculiar changes in the economic landscape of Ethiopia: a shift to higher growth path and more diversified sources of growth. The strong growth has enabled Ethiopia to make significant strides in reducing poverty, and thus has kept the achievement of some of the Millennium Development Goals (MDGs) within reach. The country's growth has been sustained largely and complemented by strong investment in the construction, manufacturing, power, tourism, banking and insurance, and real estate sub-sectors. Significant investment in agriculture, including in the irrigation schemes, has modernized the sector and insulated it from recurring drought shocks.

3. Notwithstanding these efforts, inflation has recently started edging up mainly due to increases in food prices. Structural factors have partly been responsible for rapid increases in food prices in Ethiopia in recent years. Among the factors is the rise in rural incomes recorded over the past four years, which has contributed to changes in the food consumption patterns of the rural population and aligned it to that of urban population. This development created excess demand for grains which in the past were not generally consumed by the rural population. At the same time, the pattern of agricultural cultivation has not yet shifted sufficiently towards the relevant grains to enhance supply. Consequently, there has been a significant rise in prices, in spite of an overall increase in the domestic food production.

4. In the midst of these challenges, the Ethiopian authorities have remained committed to pursuing prudent macroeconomic policies. The government fiscal balance for 2006/07 improved mainly because of cuts in spending, whilst increases in grants have also contributed positively. Monetary policy has also been tightened to significantly reduce excess reserves of commercial banks, and improve the efficacy of monetary policy, with better control over liquidity developments.

Current challenges: shocks and imbalances

5. Notwithstanding these positive developments, the Ethiopian economy is confronted with twin challenges: (i) continuing inflationary pressures; and (ii) low international reserves, which considerably limit its policy options.

6. The authorities recognize that rising inflation, exacerbated by international food and oil prices, poses a significant challenge to their plan to sustain the current real growth momentum. In particular, they are aware of the challenges posed by the surge in world oil prices, which have pushed up the oil import bill. Though inflation is expected to start subsiding in response to the earlier tightening of monetary policy, the authorities are determined to take additional measures to counter excess demand pressures that are contributing to high inflation including further adjustments to fiscal and monetary policies. The authorities are also aware that measures to scale down import growth in order to stay within the confines of the available foreign reserves remain a priority. It is against this background that the authorities expressed their plan to cut public spending and limit overall public borrowing, in order to limit import demand.

7. The authorities remain committed and have demonstrated this commitment to their development partners as to how they intend to address the current economic shocks. In turn, they expect development partners to assist by frontloading donor assistance to ease the adjustment burden and facilitate a smoother transition in the economy.

Adjustment measures to the shocks and domestic imbalances

Fiscal policy

8. Strategy of adjustment measures to the shocks and imbalances that have emerged include an important role of fiscal policy to support monetary tightening. The authorities intend to limit overall public sector domestic borrowing--including public enterprises--well below the 2007/08 budget ceiling of 2.5 percent of GDP. However, they are concerned that going as low as 1.5 percent of GDP for domestic borrowing would further squeeze the already tight government spending and the investment program. This may be counterproductive for a country with a huge development deficit and widespread poverty. Nevertheless, public domestic debt would be reduced to 25 percent of GDP by end 2007/08 from 28 percent in 2006/07. After implementation of the MDRI, all debt burden indicator ratios are now well below their respective sustainability thresholds. With a view to maintaining sustainable debt and avoiding recurrence of new debt stress, the authorities are committed to continue seeking more grants and contract loans only on concessional terms.

Monetary policy

9. The broad objectives of monetary policy will continue to maintain core inflation at a single-digit level and international reserves at 8-10 weeks of import cover. This would be

achieved by keeping broad money supply at less than 20 percent. However, the authorities also acknowledge the significant risk posed by excess demand and inflation expectations which has been partly driving inflation and may continue to do so. In this respect, the authorities are ready to further tighten monetary policy.

Exchange rate policy

10. The authorities have described Ethiopia's exchange rate regime as managed float with no pre-determined path for the movement of the exchange rate. The official exchange rate is freely determined in the daily inter-bank exchange rate market, with no explicit exchange rate target set by the National Bank of Ethiopia (NBE). The authorities have noted that the real exchange rate appreciation in recent times is largely attributable to inflation running ahead of that in competitor countries. However, they are confident that the determination to rein in inflationary pressures and to continue implementing structural reforms aimed at improving productivity and efficiency in key sectors of the economy would help stem and reverse the REER appreciation over the medium term.

Structural reforms

11. The Ethiopian authorities are aware of the key reforms necessary to strengthen the medium-term growth prospect. These include, creating a more dynamic and productive agricultural sector, strengthening the power sector to increase access and reliability of electricity supply, and improving the business environment. Efforts to improve productivity and efficiency in these key sectors are already underway. In agriculture, the reforms include investment in farm-to-market roads; encouraging private sector involvement; building agricultural credit markets; and enhancing the security of land tenure, which would help to boost agricultural productivity. Also, promoting tourism as part of its export diversification strategy is a priority. To this end, construction of a number of hotels and other infrastructure facilities are ongoing to make Ethiopia one of the top ten tourist destination in Africa by the year 2020.

12. The authorities are also committed to the development of the banking system, and efforts to introduce more competition and financial deepening are underway. It should be inspiring to note that the country that was served by one national bank is currently boasting the operation of 10 commercial banks across the country. Efforts are aimed at encouraging a diversified array of financial products and services, and extend them to the rural areas. It is important to underscore that the authorities are not against foreign banks entry but believe that the gradual and systematic process in banking reform is necessary and, therefore, measures already taken should be given sufficient time to take effect.

13. The authorities recognize the important role of private sector development to complement public investment as a way to expand the capacity of the economy. In this regard, efforts to speed up private sector development in general and private investment in particular are underway. To this end, a number of incentive packages have been implemented

under Regulation No. 84/2003 to encourage and promote both domestic and foreign investors. These incentives include income tax holidays, exemption from taxes on remittance of capital, loss carry forward, and customs duty exemptions.

Conclusion

14. The authorities recognize the challenges of macroeconomic management, and remain committed to taking appropriate measures to address the current imbalances. In this regard, they will remain engaged with the Fund, and would appreciate the Fund's catalytic role in providing the needed signals for development partners' support of their efforts to achieve macroeconomic stability, sustain growth, reduce poverty, and achieve the Millennium Development Goals