



THE FEDERAL DEMOCRATIC REPUBLIC OF ETHIOPIA

October 2014

2014 ARTICLE IV CONSULTATION—STAFF REPORT; PRESS RELEASE; 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 2014 Article IV consultation with Ethiopia, the following documents have been released and are included in this package:

- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on September 24, 2014, following discussions that ended on June 25, 2014, with the officials of Ethiopia on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on September 5, 2014.
- An **Informational Annex** prepared by the IMF.
- A **Debt Sustainability Analysis** prepared by the staffs of the IMF and the World Bank.
- A **Press Release** summarizing the views of the Executive Board as expressed during its September 24, 2014, consideration of the staff report that concluded the 2014 Article IV consultation with Ethiopia.
- A **Statement by the Executive Director** for The Federal Democratic Republic of Ethiopia.

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

Selected Issues Paper

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

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THE FEDERAL DEMOCRATIC REPUBLIC OF ETHIOPIA

STAFF REPORT FOR THE 2014 ARTICLE IV CONSULTATION

September 5, 2014

KEY ISSUES

Context: Ethiopia's investment-led development strategy has delivered robust growth and progress toward Millennium Development Goals (MDGs). Restrained fiscal and monetary policies have helped maintain macroeconomic stability, although the financing mode of the continuing large-scale investment through public enterprises could risk undermining macroeconomic stability. A cautious policy stance will be critical in preserving the recent gains.

Focus of the consultation: The discussions centered on policies to sustain strong economic growth and promote structural transformation. Issues covered included: (i) the policy mix to preserve macroeconomic stability and debt sustainability; (ii) the public sector investment program and its financing; and (iii) financial deepening, export competitiveness and the business climate.

Outlook and Risks: Growth is expected to remain strong, driven mainly by agriculture and services. Inflation should continue to remain in single digits, in line with a tight monetary policy. Key downside risks include insufficient financing for infrastructure investment in the Growth and Transformation Plan (GTP), lower prices of main export commodities, and weather-related shocks, particularly a drought.

Policy mix: Staff recommendations focused on sustaining a cautious policy stance, prioritization of public investments and closer monitoring of state-owned enterprises to ensure prudent borrowing in the context of a medium-term debt management strategy, enhancing export competitiveness, greater resource mobilization and development of the financial sector, and a more prominent role for the private sector. Structural improvements in the functioning of the money and foreign exchange market and building foreign reserves to at least three months of imports were suggested to enhance resiliency. The need for greater interest rate and exchange rate flexibility and improved competitiveness of the traded goods sector, including through exchange rate adjustment, was underscored.

Approved By
Michael Atingi-Ego
and Masato Miyazaki

Discussions were held in Addis Ababa from June 11–25, 2014. The mission met with Prime Minister Hailemariam Desalegn, National Bank Governor Teklewold Atnafu, Economic Advisor to the Prime Minister Newai Gebre-ab, the State Minister for Finance and Economic Development Abraham Tekeste, other senior officials, and representatives of the donor, business, and civil society communities. The mission team comprised Mr. Wajid (head), Mr. Yèhoué, Ms. Radzewicz-Bak, and Mr. Ramirez (all AFR). Mr. Mikkelsen (Resident Representative) participated in the discussions. Ms. Teferra (OED) and World Bank staff attended key meetings.

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BACKGROUND

1. Ethiopia's development strategy is geared toward economic and social development (Box 1). Pro-poor economic growth over the last decade has led to a considerable increase in per capita GDP and an impressive drop in the national poverty rate (Figures 1 and 2).¹ Significant progress has been made in achieving the MDGs, including: increased immunization and reduced child mortality; higher enrollment rates in primary schools; and better water sources and sanitation facilities (Table 7). Despite the progress, however, the poorest of the poor are yet to benefit to the same extent.

Box 1. Ethiopia: The Growth and Transformation Plan 2010/11–2014/15

Ethiopia's development strategy is implemented through a succession of five-year national plans. The current plan—The Growth and Transformation Plan" (GTP)—spans 2010/11–2014/15 and is aimed at sustaining rapid, broad and equitable economic growth, and achieving the Millennium Development Goal (MDG). The longer-term objective is to eradicate poverty, bring about structural transformation of the economy and reach a middle-income status by 2020–25.

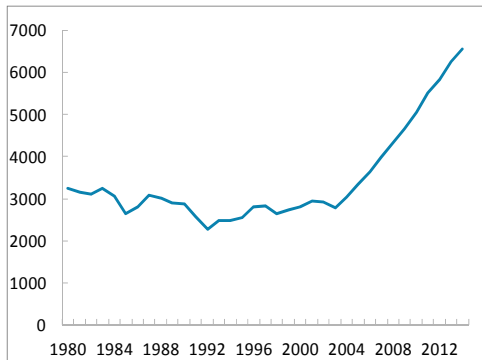
The GTP projects an average growth rate of 11.2 percent over the 5 year plan period in the base case. The plan seeks to ensure sustainability of growth by pursuing its objectives within a stable macroeconomic framework. Among its strategic pillars are: sustaining rapid and equitable economic growth; maintaining agriculture as a major source of economic growth; creating conditions for industry to play a key role in the economy; enhancing expansion and quality of infrastructure and social development; building capacity and deepening good governance; and promoting gender and youth empowerment and equity.

The structural transformation of the country is pursued through scaled-up public investments, such as in roads, railroads, hydro-electric generation plants, sugar factories, housing, and other projects. The strategy also assumes maintaining high share of fiscal spending to support human capital development, including through education, and technical and vocational trainings.¹

¹ The macroeconomic objectives and the government development strategy for 2010/11 and 2014/15 envisaged in the Growth and Transformation Plan are discussed in: The Federal Democratic Republic of Ethiopia: 2013 Article IV Consultation, Country Report No 13/308, IMF, October, 2013 <http://www.imf.org/external/pubs/cat/longres.aspx?sk=40991.0>; The Federal Democratic Republic of Ethiopia: Selected Issues Paper, Country Report No 13/309, IMF, October, 2013 <http://www.imf.org/external/pubs/cat/longres.aspx?sk=40992.0>; The Federal Democratic Republic of Ethiopia: 2012 Article IV Consultation, Country Report No 12/287, IMF, October, 2012 <http://www.imf.org/external/pubs/cat/longres.aspx?sk=40053.0>;

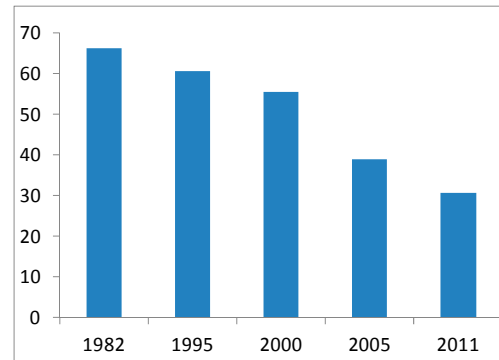
¹ Based on the international standard of US\$1.25 a day, purchasing-power-parity adjusted (World Bank's World Development Indicators, August 2013).

Figure 1. Ethiopia: GDP per capita
(in constant 2010 birr)



Source: IMF Staff Estimates.

Figure 2. Ethiopia: Poverty Headcount Ratio at US\$1.25 a day (PPP)
(in percent of population)



Source: World Development Indicators, WB.

2. Developments in indicators of living standards and welfare are promising. The Human Development Index shows Ethiopia performing better than many low-income countries.² Income distribution, as indicated by the Gini coefficient (.336), is relatively less skewed than other low-income countries. Ethiopia also scores better than the median African country on governance attributes—especially social welfare, education and health (Figure 3).

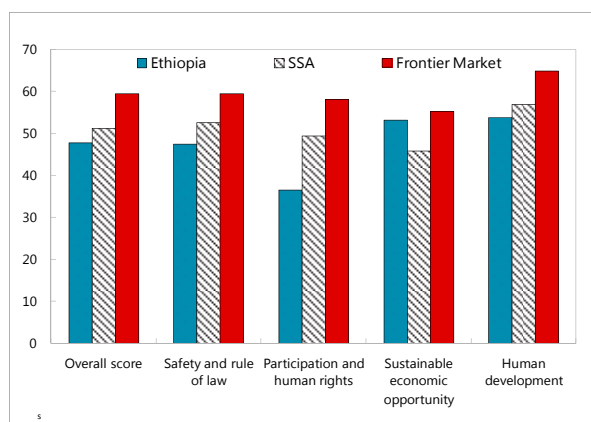
3. Sustained and robust growth has helped to alleviate unemployment in urban areas. Overall unemployment in urban areas declined to 16.5 percent in 2013 from 20.4 percent in 2009 (Figure 4). Both female and male unemployment has fallen and the gap between the two groups has narrowed. Still, the unemployment remains high, especially among young females.

4. The recommendations of the 2013 Article IV consultation have only been partially implemented. Tight monetary policy has kept inflation in the single digits and reduced negative real interest rates. There has been little progress in improving liquidity management and the functioning of the money and foreign exchange markets. Some efforts are being undertaken toward enhancing the business environment, especially access to credit for the private sector, but the main emphasis continues to be on physical infrastructure, which is believed to crowd-in the private sector in the long-run.

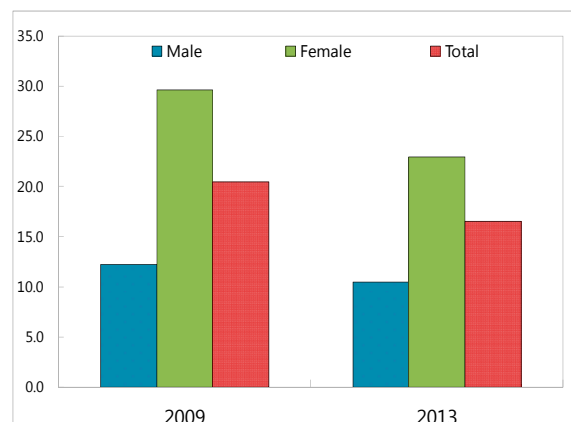
² The Human Development Index is a composite index of life expectancy, education and income, and it is used to rank countries in terms of human development; the index is published by the United Nations. The Mo Ibrahim Index provides assessment of governance in African countries; compiled annually in partnership with experts from African institutions.

Figure 3. Ethiopia: Mo Ibrahim Index Ranking**Categories**

(higher numbers=worse ranking)



Source: Mo Ibrahim Index

Figure 4. Ethiopia: Urban Unemployment Rate

Source: International Labor Organization

RECENT DEVELOPMENTS AND OUTLOOK

A. Recent Developments

5. The economy continues to grow fast in 2013/14 on the heels of very strong real GDP growth in 2012/13. Based on the preliminary information on crop and cereal production and industrial production spurred by large-scale public and foreign direct investments, staff projects the economic growth in the 8.0–8.5 percent range in 2013/14 and 2014/15. Staff projections incorporate a downward adjustment from official figures to take into account the uncertainty around the underlying growth rate due to weaknesses in the national account statistics. The authorities' projections are more optimistic (in the 11.0–11.4 percent range).

6. Fiscal policy at the general government level remains cautious. The general government budget execution in 2013/14 reflects conservative spending. Recurrent spending is estimated to remain at 7.4 percent of GDP, and the capital spending-to-GDP ratio will only increase by about 0.3 percentage points to 11.0 percent of GDP. Although tax revenue-to-GDP is estimated to improve in 2013/14, the overall revenue-to-GDP ratio is estimated to fall from about 14.6 in 2012/13 to about 14.1 in 2013/14, mainly on account of nontax revenue, as state-owned enterprises were allowed to retain earnings for reinvestment instead of paying dividends to the government. The staff estimates the general government budget deficit, including grants, to be 2.7 percent of GDP in 2013/14, compared to 2.0 percent of GDP a year ago.

7. Public enterprises continue to provide an expansionary impulse, absorbing much of available credit and foreign exchange. They borrowed heavily from the banking system and externally to finance their investments. Banking system credit flow to public enterprises in the first ten months of 2013/14 was some 4 percent of GDP, not taking into account non-bank financing of

the Grand Renaissance Dam. Based on the first ten months of the current fiscal year, external borrowing by these enterprises is likely to reach 3.3 percent of GDP for the year. Consequently, the financing of the overall public sector is likely to have been on the order of 10 percent of GDP. Public and publicly guaranteed (PPG) external debt is estimated to increase to about 23 percent of GDP in 2013/14 from 20.5 percent of GDP in 2012/13.

8. Tight monetary policy has supported achieving the NBE's inflation objective in 2013/14. Inflation remained in the single digits throughout the year and was 8.5 percent in June 2014, with food prices rising by 6.2 percent and non-food inflation stubbornly in the double-digits.³ Base money, the nominal anchor of the monetary policy, increased by 17.5 percent in April 2014, driven mainly by claims on government (by 19.6 percent) and to lower degree by claims on non-government (by 11.2 percent). Other items net (OIN) contracted significantly, reflecting the redemption of the National Bank of Ethiopia's (NBE's) certificates of deposit (CDs) issued to private banks in 2013 to offset the potential liquidity injection from a reduction in the reserve requirements.⁴

9. The developments in the external sector present a mixed picture, with a substantial deterioration in the trade balance offset by net inflows on services and transfers. The weakening of trade balance reflects a sharp decline in the price and volume of Ethiopia's main commodity goods (coffee and gold) due to subdued external demand conditions. This was offset, however, by solid volume growth in other exports such as oilseeds, pulses, leather products, live animals, and flowers. Demand for imports remained strong, driven by the investment-led economic growth. Imports of goods are estimated to increase by 12.7 percent in 2013/14, led by fertilizers, petroleum products, and capital goods.

10. Expanding services exports partly made up for the large trade deficit. Transportation and travel service exports performed well in 2013/14, boosted by the aggressive expansion of Ethiopian Airlines and growing tourism. Private and official transfers also increased in FY2013/14, reflecting continuing strong growth in remittances. The current account deficit, nonetheless, is estimated to have widened from US\$2.8 billion (6.0 percent of GDP) in 2012/13 to US\$3.5 billion in 2013/14 (7.1 percent of GDP). It was financed largely by concessional and non-concessional inflows as well as by foreign direct investment (FDI). Substantial inflows on the capital account also facilitated a modest build up in the NBE's reserves.

³ Non-food inflation has been driven mostly by higher cost of housing, water, electricity and gas.

⁴ In March 2013, after lowering reserve requirements on deposits from 10 to 5 percent, the NBE issued CDs to sterilize liquidity. Holdings of CDs were recorded under OIN, and all the commercial banks were obligated to allocate the difference stemming from the lowering of reserve requirements in the NBE's instrument. The CDs held by private commercial banks with 1 year maturity were redeemed in March and April 2014, returning liquidity to the system.

11. Despite import-related demand for foreign exchange, the exchange rate adjusted only gradually, in line with the NBE's managed float policy. While the premium in the parallel market remained modest (4.6 percent in May), the gradual nominal depreciation was likely insufficient to address excess demand for foreign exchange, and prevent an appreciation of the real effective exchange rate and loss of competitiveness.

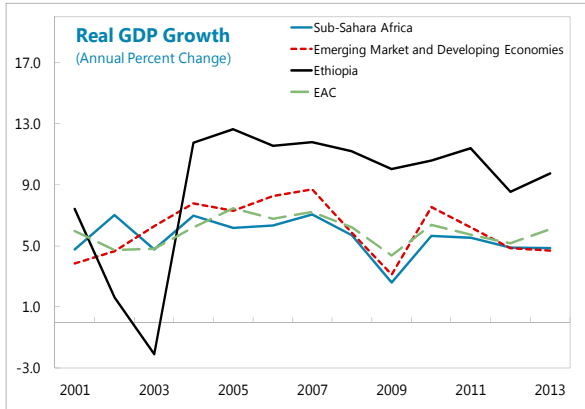
B. Medium Term Outlook and Risks

12. Outlook. Overall economic growth is projected to remain strong (in the upper single digits) in the coming years, but may fall short of the government's ambitious targets. Constraints on domestic and external financing for large-scale public investment; an uncertain external environment with anemic recovery of Ethiopia's main trading partners; and a lack of supportive policies for private sector development are among the downside risks to the outlook. Inflation is projected to remain in the single digits, but given the stickiness in non-food prices it is expected to remain in upper range of the NBE's objective. The current account deficit as a percentage of GDP is expected to improve, conditional on the government's efforts toward diversification of the export base and boosting productivity of export-oriented industries bearing fruit.

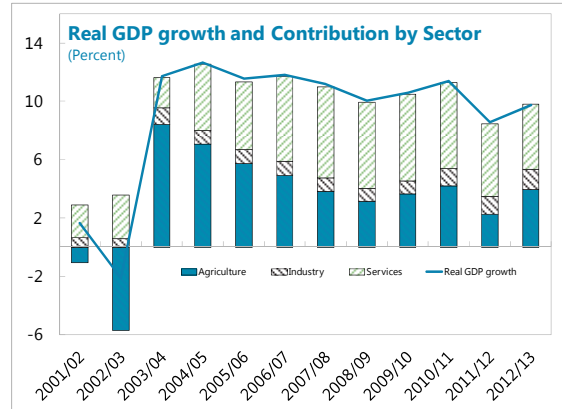
13. Risks. Despite a generally positive outlook, Ethiopia is subject to risks. These include: (i) constraints on the financing of a large public sector investment program; (ii) sustained decline in commodities prices and the re-emergence of foreign exchange shortages; (iii) slower recovery in advanced economies and growth slowdown in the major emerging market countries; and (iv) weather-related shocks, particularly a drought in the Horn of Africa (Table 1).

Figure 5. Ethiopia: Recent Economic Developments

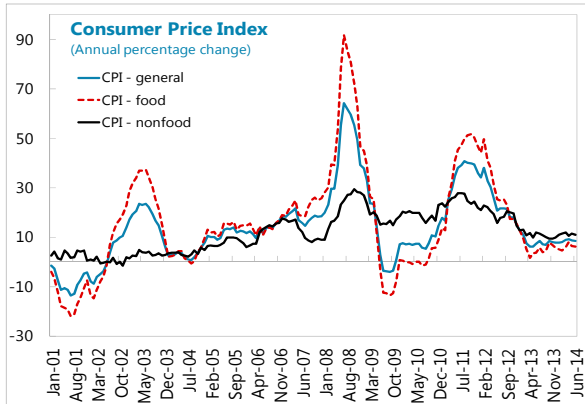
Growth remains robust and significantly above the average for SSA, LICs and EAC...



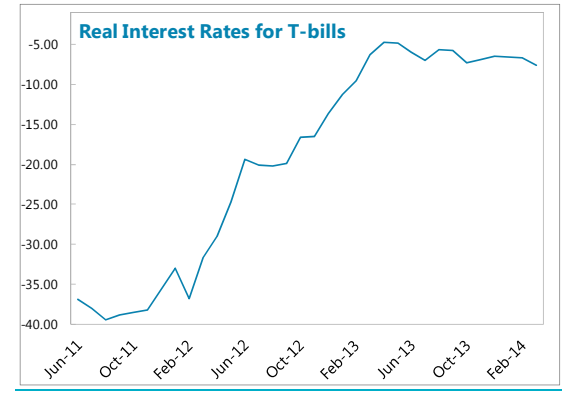
...driven by agriculture and services.



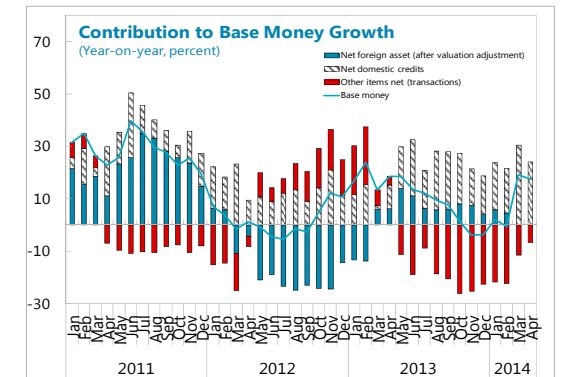
Inflation returned to single digit, but non-food prices remain stubbornly in double digit territory.



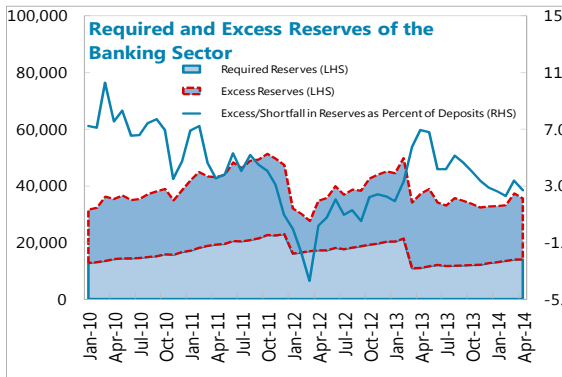
Despite declining inflation, real interest rates for T-bills remain negative.



Contraction in OIN mitigated the growth in net domestic assets.



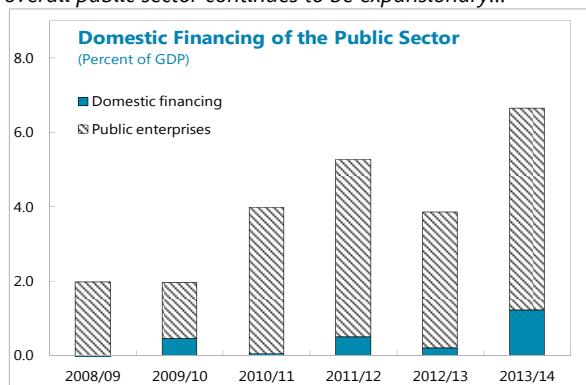
Excess reserves in the banking system declined.



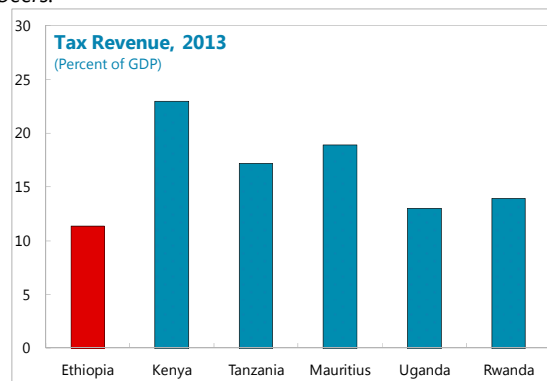
Sources: IMF staff estimates and World Development Indicators.

Figure 5. Ethiopia: Recent Economic Developments (concluded)

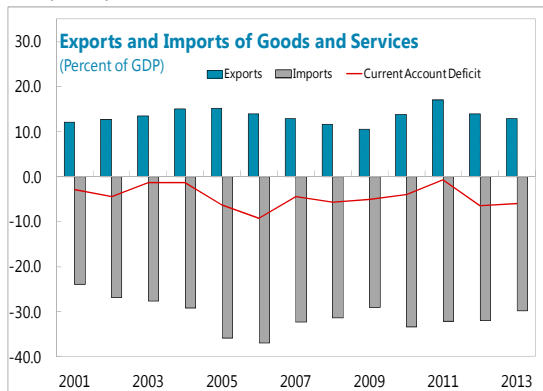
General government stance has been cautious, but the overall public sector continues to be expansionary...



...with tax collection performance lagging behind the peers.



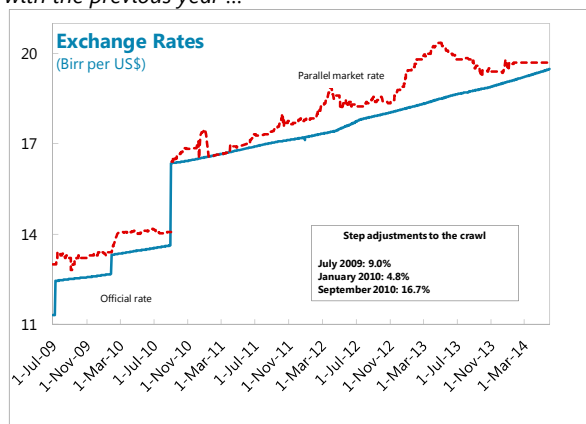
The exports performance remains weak...



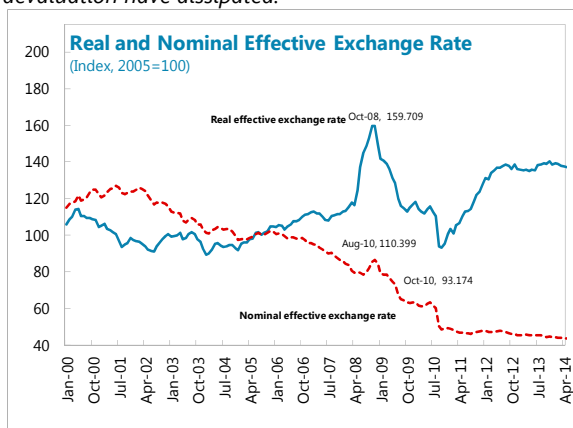
... constraining adequate accumulation of reserves.



The premium on the parallel market declined comparing with the previous year ...



...competitiveness gains from earlier exchange rate devaluation have dissipated.



Source: IMF staff estimates.

Table 1. Ethiopia: Risk Assessment Matrix

Source of Risks	Relative Likelihood	Impact if Realized	Policy Response
External Risks			
Advanced economies: Lingering recovery process, with lower-than-anticipated potential growth and persistently low inflation due to a failure to fully address legacies of the financial crisis, leading to global stagnation.	High	The impact of such a shock would include less demand for commodities; as a result commodity prices would decline and reduce export earnings.	Restrain fiscal policy, while shielding low-income and vulnerable households.
Emerging markets (EMs): Maturing of the cycle, and incomplete structural reforms leading to prolonged slower growth.	High	A prolonged slower growth in EMs would lead to commodity price decline with a negative impact on Ethiopian exports. It would result in severe shortfalls of financing (especially from China), and a decline in remittances and FDIs. The financing of the GTP would be jeopardized with significantly slower growth.	Restrain fiscal policy while shielding low-income and vulnerable households, in particular appropriate scaling down public enterprises borrowings and public investment.
Growth slowdown in China: Continued buildup and eventual unwinding of excess capacity, subsequently resulting in a sharp growth slowdown and large financial and fiscal losses (medium-term).	Medium	FDI from China, which has been rising rapidly across sectors, could decrease, slowing development of newly emerging export sectors, like textile and leather manufacturing. Major infrastructure investments, particularly in power, telecom, rails and roads, may not be fully financed, delaying the implementation of the GTP and slowing down the growth.	Prioritize and pace the large-scale investment.
Sustained decline in commodity prices triggered by deceleration of global demand and leading to prolonged foreign exchange shortages.	Medium	It would lead to export revenue shortfall, which in turn would negatively affect the import of goods, e.g., fertilizers, petroleum products and capital goods. The latter, required for continuing investment-led development strategy may negatively impact sustaining high and long-term economic growth. Rapid devaluation, leading to higher inflation and larger fiscal deficit.	Undertake the structural reforms aimed at: (i) improvements in productivity of export-oriented industries, (ii) diversification of export base, (iii) reforming functioning of foreign exchange market and buildup of foreign reserves to 3 months of import cover, and (iv) removing binding constraints on business operations.

Table 1. Ethiopia: Risk Assessment Matrix (concluded)

Source of Risks	Relative Likelihood	Impact if Realized	Policy Response
Domestic Risks			
Lack of sufficient financing for GTP.	High	Slow-down of economic growth.	Appropriate pacing of public enterprises investment and better prioritization of infrastructure investment.
The return of drought to the Horn of Africa.	Medium	Higher food prices, leading to an increase in inflation and lower growth.	Shielding poor households and tight monetary policy, minimizing second round effects.

¹The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of Fund staff). The relative likelihood of risks listed is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability of 30 percent or more). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly.

POLICY DISCUSSIONS

14. Ethiopia has achieved considerable success in implementing its development strategy, but sustaining it is increasingly challenging. Recent macroeconomic stability, with robust economic growth and single digit inflation, is not fully entrenched in the presence of negative real interest rates, an overvalued exchange rate, and low reserve coverage. Growth has also fluctuated in the context of global and domestic shocks and the country remains vulnerable to terms of trade shocks. Export diversification and competitiveness lag behind those of other African countries.

15. Achieving high growth rates set out in the GTP requires continued investments and resource mobilization. The GTP envisages a significant part of investment to be undertaken by public enterprises with average annual borrowing over the five year period of some 15 percent of GDP, of which some two-thirds is to be borrowed externally. With binding external financing constraints, critical investments need to be financed increasingly from domestic sources, implying a need to mobilize substantial domestic savings.

16. The current level of domestic savings is insufficient to finance the high public investment. The relatively low GDP per capita means that the scope for substantial mobilization of domestic savings in the short run is limited. At the same time, the government's policy of keeping the real interest rates negative is not conducive to saving and distorts financial intermediation. Experience in the first three years of the GTP suggests that large scale public investment financed domestically squeezes the availability of credit for the rest of the economy. Thus, an adjustment in policies to establish better balance between the public and private sectors is warranted. There is also

a risk that the investment levels envisaged under the development strategy may run up against the absorptive capacity of the economy.

Box 2. Ethiopia: The Macroeconomic Implications of Scaling up Infrastructure and Energy Investments¹

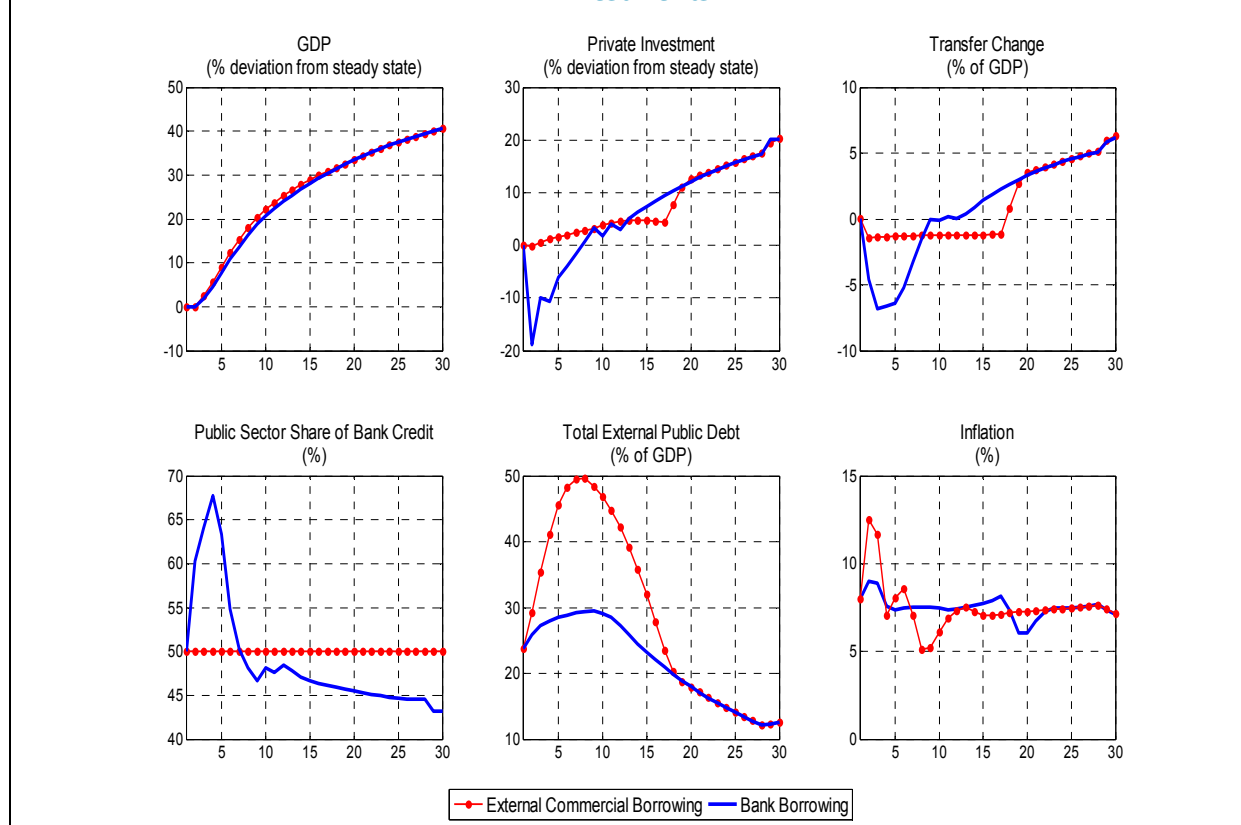
Staff discussed with the authorities the macroeconomic effects of scaling up public investment using a variant of the open-economy Debt, Investment, and Growth (DIG) model developed by Buffie et al (2012). The benchmark DIG model features domestic production of traded and non-traded goods, public investment in infrastructure, alternative financing mechanisms (external concessional, external commercial, and domestic), and fiscal rules that target debt sustainability. The customized model for Ethiopia also incorporates: (i) a state-owned energy sector that exports electricity to neighboring countries and sells to firms and households at controlled, low prices; (ii) a state-owned banking sector that fixes interest rates and lends a large fraction of deposits to the public sector.

The model and the investment program were calibrated to capture the key characteristics of Ethiopia's GTP. The calibration assumes high rates of return to infrastructure (20 percent) and energy (30 percent) as well as large efficiency gains from construction of the Renaissance Dam.² Consistent with the big-push investment program envisioned by the GTP, the simulations postulate very rapid increases in energy investment and more gradual increases in other infrastructure investment. The stock of infrastructure capital doubles in the long run, while the path for energy investment and the efficiency gains from the Renaissance Dam increase total energy supply four-fold (300 percent) at the 10-year horizon. The gap between investment outlays and concessional loans was covered by a combination of fiscal adjustment and either additional borrowing from the domestic banking system or additional external commercial borrowing.

The simulations reveal that, despite positive long-run growth effects, transition challenges and trade-offs accompany the different financing strategies. Reliance on domestic bank borrowing requires substantial fiscal adjustment to prevent macroeconomic instability—transfers need to decrease by more than 5 percent of GDP within two years (blue line Figure 6). The surge in public investment also crowds out private investment and triggers a sharp increase in inflation in the short run. By contrast, external commercial borrowing relaxes the national budget constraint. The extra resources allow public investment to increase without cuts in recurrent expenditure, temporary crowding-out of private investment, and a sharp increase in inflation (red lines with dots). These gains have to be balanced against the risks associated with significant increases in the ratios of non-concessional debt and total external debt to GDP. The tradeoffs in other scenarios involving gradual increases in energy prices and slower scaling up of public investment were also analyzed.

¹ Prepared by Felipe Zana from the IMF's Research Department based on a general equilibrium model to analyze the growth effects and tradeoffs in financing the scaling up of various public investments, as discussed in the accompanying Selected Issues paper.

² The macroeconomic effects of the large-scale public investments, including on growth, depend on the structural conditions of the economy. The baseline calibration of key parameters, such as the rates of return on infrastructure and energy, and the efficiency of public investment are favorable and yield positive medium-to long-run macroeconomic effects. Under less favorable calibration, reflecting weaker structural conditions, the positive effects could be significantly diminished.

Figure 6. Ethiopia: The Macroeconomic Implications of Scaling up Infrastructure and Energy Investments

17. Staff's baseline projections assume the continuation of current policies (Table 2). These include constraints on private banking operations, directed lending with artificially low real interest rates, and allocation of foreign exchange to government's priority sectors. Without policy adjustment, sustained high growth sought by the authorities over the long-term may not be achievable. Scaled-up public investment financed by domestic borrowing risks generating inflationary and further crowding out the private sector. In absence of policy correction, the staff estimates growth tapering in the medium-term to the 7.5–8.5 percent range, below that targeted by the authorities.

18. Policy discussions focused on sustaining high economic growth while preserving macroeconomic stability and debt sustainability. Key recommendations include (i) rationalizing and prioritizing public sector investment, especially for state-owned enterprises; (ii) real and external sector reforms to support structural transformation; (iii) strengthening financial sector policies to promote inclusiveness and market development, bringing real interest rates to positive levels, and ensuring more flexible exchange rates and higher exchange reserves; and (iv) improving the business environment and expanding the private sector's role in the economy. The implementation of these recommendations would facilitate financial development that should enable less distortionary financing of the GTP that is consistent with debt sustainability.

19. Staff’s alternative scenario, which assumes implementation of the corrective policies mentioned above, yields stronger growth, while safeguarding macroeconomic stability and reducing vulnerabilities (Table 6). Under this scenario, the growth rate is projected to rise to 10.5 percent by 2018/19, inflation is targeted to decline to 6 percent by 2015/16, and current account deficit is estimated to narrow to 2.2 percent of GDP. Positive real interest rates will help to mobilize deposits, more flexible and better adjusted exchange rate will improve the competitiveness of exports, and private sector’s access to credit from the banking system will increase.

A. Fiscal Policy and Public Sector Enterprises

20. The fiscal stance embodied in 2014/15 general government budget is appropriately restrained (Tables 3a and 3b). Owing to government’s revenue mobilization efforts, the revenue-to-GDP ratio is projected to increase from about 14.1 percent in 2013/14 to 14.5 percent in 2014/15. Reflecting the ongoing efforts to improve tax revenue collection, the tax-to-GDP ratio is projected to rise from 13.0 percent 2013/14 to 13.3 percent in 2014/15 but nontax revenue will remain broadly the same on account of the continuation dividends retaining policy for state-owned enterprises. The 2014/15 budget targets the general government deficit at 3 percent of GDP, to be financed in part by the NBE. Staff reiterated, as in the 2013 Article IV consultation, the importance of refraining or strictly limiting recourse to deficit financing by NBE.

21. Revenue mobilization remains a challenge and compares unfavorably with regional peers, reflecting the limited private sector tax base. Tax-to-GDP ratio in Ethiopia was 12.5 percent in 2013 compared to about 23 percent in Kenya, 19 percent in Mauritius, and 17 percent in Tanzania. Tax revenue could be boosted by broadening the tax base (especially by promoting private sector activity), strengthening customs and tax administration. The expansion of cash registry machine should continue and be strengthened with unannounced site visits by inspectors to minimize fraudulent or tax avoidance behaviors by tax payers. The cash registry machines also need to be introduced in the remaining three regions and tax payer education enhanced.

22. Progress has been made on the Ethiopian Revenues and Custom Authority’s (ERCA) reform agenda and further progress on implementation is needed. Taxpayer compliance and ERCA’s record on the achievement of revenue targets in the context of already low tax revenue-to-GDP ratio are weak. The authorities should intensify efforts to develop and implement a national Compliance Management and Enforcement Strategy and an Enterprise Risk Management Strategy. Priority areas where ERCA’s management needs to focus include: (i) compliance, particularly with respect to registration, arrears collection, underreporting, and VAT refund; (ii) staff retention as ERCA is experiencing high attrition rates of well trained staff; and (iii) ethics and integrity.

23. Staff encouraged the authorities to consider the revenue potential of reducing tax expenditure and tax incentives and improved tax collection.⁵ In particular, full implementation of the ERCA's reform agenda with a view to realizing tax revenues at levels close to regional comparators should be considered. Staff alternative scenario, assuming the implementation of the IMF FAD recommendations, indicate a possible annual tax revenue gain of up to 3 percentage points of GDP over the next five years.

24. Spending continues to have a strong pro-poor focus and the 2014/15 budget is in line with this policy. The ratio of poverty-reducing expenditure to GDP is being kept steady despite resource constraints, while defense spending is declining as a ratio of GDP. Poverty-related expenditures (including those financed by external project loans) amounted to more than 12 percent of GDP in 2012/13. This is estimated to be the same in 2013/14 as well as in the 2014/15 budget.

25. The expansionary impulse from public enterprises is contributing to a build-up of domestic and external imbalances. Staff stressed the need for establishing the consolidated fiscal position, which includes public enterprises, as an overall fiscal anchor in the long-run in order to comprehensively assess the macroeconomic impact of the activities of public enterprises and sustainability of their financing. Staff made the case for reducing domestic public sector borrowing by either prioritizing and gradually phasing in certain investment projects or attracting more external financing at appropriate terms (including concessional loans and foreign direct investment).

26. Public enterprises and banks continue to be a source of significant build-up of contingent liabilities for the government. Lack of detailed information on their financial situation, including revenue stream, structure of expenditures, financing, and debt make it difficult to comprehensively assess the overall public sector finances. Staff advised the authorities to establish a high-level mechanism to start gathering data on the consolidated public sector, including public enterprises. It stressed the importance of timely financial statements of all major public enterprises for establishing the overall fiscal anchor. In this regard, it would be desirable to establish a specific timeline for the disclosure of audited financial statements of public enterprises.

27. Public financial management (PFM) reforms are progressing and yielding improvements in the budgetary processes. Program-based budgeting is in the third year of full implementation at the federal government level. For regional governments, the roll out is planned and the road map has been prepared. Cash management reform, with the aim of reducing idle cash in the various government accounts and improving the quality of fiscal reporting, is progressing well. Staff stressed the need to maintain the momentum in these areas.

⁵ Since 2012 FAD has undertaken a series of TA missions that have made specific recommendations for rationalizing tax incentives and tax expenditures.

Authorities' views

28. The authorities broadly concur with staff assessment of the fiscal sector at the general government level, in particular as regards revenue mobilization. They expect the planned administrative measures to deliver substantial revenue increases but stress the need for continued technical assistance from the Fund and other development partners to support their efforts. However, they disagree on the importance of an overall consolidated fiscal anchor including public enterprises and questioned the meaningfulness of overall debt sustainability of the consolidated public sector. In their view, debts of public enterprises without explicit guarantees do not represent contingent liabilities of the government. At the same time, they agreed on the need to monitor the financial situation of public enterprises and indicated their intention for establishing an agency for doing so.

B. Public Sector Debt

29. Accumulation of external debt accelerated in 2012/13 and 2013/14. The stock of outstanding public sector external debt reached US\$12.2 billion in the first half of FY2013/14 and was US\$ 11.2 billion at the end of FY2012/13, reflecting mainly additional concessional multilateral loans. Of the additional loans disbursed in FY2012/13 and first half of FY2013/14 (about US\$2.4 billion, including Ethiopian Airlines), one third was for transport and communication sector, 18 percent for electricity related projects and 12 percent for highways. Debt service payments have increased in recent years, but favorable terms have kept the debt burden at low levels.

30. Domestic debt has grown with the financing needs of the general government. Total domestic debt was about 16.9 percent of GDP at the end of FY2012/13, 60 percent of which was accounted for by direct advances from NBE, 28 percent by treasury bills, and 13 percent by government bonds held mostly by NBE and Commercial Bank of Ethiopia (CBE).

31. The risk of external and public debt distress remains low, but is on the cusp of transition to moderate. External debt-to-GDP ratio is projected to increase further in the medium-term and return to low levels in the long-run. Large disbursements associated with the implementation of investment projects under the GTP are projected during the next 6 to 7 fiscal years, with non-concessional disbursements increasing from around US\$1 billion in FY2014/15 to US\$ 2.5 billion in FY2016/17, and remaining above US\$1 billion until FY2018/19.

32. The authorities need to monitor closely the debt levels and the terms and conditions of the new loans. Debt indicators and sensitivity analysis suggest that Ethiopia is on the border line of low and moderate risk of debt distress. Potential changes in the risk assessment from low to moderate can be triggered by a terms-of-trade shock, and higher than projected external debt. Thus, prudent borrowing levels in the context of a medium-term debt management strategy remains key to sustaining low risk of debt distress.

Authorities' views

33. Authorities do not concur with the staff's assessment of the public debt. They maintain that Ethiopian-Telecom liabilities, like those of Ethiopian Airlines, are not guaranteed by the government and hence should not be added to government debt. They explain that both these entities operate as commercial enterprises. Ethiopian Airlines discloses audited annual financial statements and Ethiopian-Telecom is in the process of doing so.

C. Monetary and Exchange Rate Policy

34. Monetary policy stance has been consistent with keeping inflation in single digits. Base money growth in 2013/14 was in line with the NBE's inflation objective, helped by limited recourse to the NBE for financing the budget. Staff stressed that, with inflation hovering toward the upper end of the authorities' target and the persistently high non-food inflation exacerbating the vulnerability to food price shocks as well as the potential expansionary effect of private banks' redemption of CDs issued to them by NBE last year to offset the reduction in reserve requirements, monetary policy stance would need to be cautious and consistent with further consolidating the gains on inflation and supporting high economic growth. The authorities indicated that monetary policy will remain anchored on base money and in line with nominal GDP growth at 18 percent in 2014/15.

35. Staff argued that conditions were ripe for developing market-based instruments of indirect monetary control. A key requirement for the effective use of such instruments of liquidity control would be nominal interest rate flexibility. Since the prevailing interest rates on treasury bills are unlikely to be attractive, there is a need to gradually raise interest rates to activate the treasury bills market. This should reduce the reliance on direct measures for liquidity management, improve the monetary transmission mechanism, and establish a benchmark yield-curve, allowing for the pricing of other financial instruments. It will also help to create pre-conditions for the use of treasury bills as collateral for interbank transactions and improve functioning of liquidity facilities at the NBE that are important for better liquidity management at commercial banks.

36. The NBE bill purchase requirement continues to severely constrain private commercial bank operations. The measure, introduced in 2011, requires commercial banks to purchase NBE bills equivalent to 27 percent of the new loan disbursements. It was intended to fund the Development Bank of Ethiopia (DBE) to provide project financing in priority areas at preferential interest rates, but it has only been partially effective in this regard given that a significant proportion of such funding has been invested by DBE in treasury bills.⁶ In the presence of the reserve requirement, the liquidity requirement, and an additional requirement for banks to hold 40 percent of their loans in short-term credits, this measure remains a major distortion in financial intermediation and should be phased out.

⁶ Owing to long lead time for project appraisal and approval at DBE and prudential limits on single borrowers.

37. Consistency between monetary and exchange rate policies is important to ensure orderly conditions in credit and foreign exchange markets. This requires regular presence of the NBE to achieve its exchange rate objective, but the NBE's limited liquidity instruments and reserve cushion make this difficult.⁷ Insufficient adjustment in the pricing of credit and foreign exchange means that excess credit or foreign exchange demand is not adequately addressed. Staff stressed that better market functioning and price setting mechanisms for the exchange rate, along with greater interest rate and exchange rate flexibility are needed, not only to clear the foreign exchange market, but also to promote the competitiveness of the traded goods sector. The NBE's objective to increase its foreign exchange reserve by US\$300 million to US\$3.0 billion (about 1.9 months of imports) by the end of 2014/15 and further to the equivalent of 3 months of imports over the medium run is a step in right direction that could be facilitated by improvement in the functioning of the foreign exchange market.

Authorities' views

38. The authorities agreed with the staff on the importance of a cautious monetary stance and the need to develop monetary policy instruments and the money market. They stressed their commitment to the base money target, consistent with broader macroeconomic objectives and other monetary targets. They indicated that the flexible pricing of government securities would be dependent on sustaining low inflation, and mentioned their plans to establish a designated unit within the NBE to coordinate efforts on establishing an active secondary market for government securities. They disagreed with the staff that the 27 percent of NBE bills purchase requirement was a distortion and explained that it was intended to mobilize excess liquidity in private banks to finance industrial projects. They considered the measure successful and only constrained by prudential limits, and reiterated that it will remain in place in the foreseeable future. The authorities also explained that DBE is working toward reducing time needed for project assessment and approval, which was another reason for its purchases of T-bills as part of its liquidity management.

D. Financial Sector Development

39. Financial sector depth and diversification is gradually increasing even though development efforts in this area lag behind those in the real and social sectors. The financial system remains bank-centric and dominated by one state-owned bank, the CBE. Although the number of privately-owned institutions and their share of total assets are gradually increasing, the banking sector remains highly concentrated and segmented, and the CBE's dominant position creates an uneven playing field in the industry.⁸

⁷ The objectives of monetary policy include maintaining price and exchange rate stability and supporting economic growth. In the context of exchange rate, the NBE conducts regular interventions to reduce exchange rate volatility and ensure stable path of exchange rate depreciation.

⁸ The assets of three largest commercial banks account for 78.9 percent, significantly above the average for SSA and LICs.

40. The banking system is expanding and the structure of its liabilities and assets is evolving. Growth in deposits has been robust, as commercial banks have branched out in previously unbanked areas. The share of savings and time deposits in total deposits has risen and competition for time deposits has pushed up interest rates on them. In 2013/14 some 80 percent of bank of financing was channeled to infrastructure investments, industry, international trade, and housing and construction. In recent years, industry, housing and construction, in particular, have increased their share in total credit.

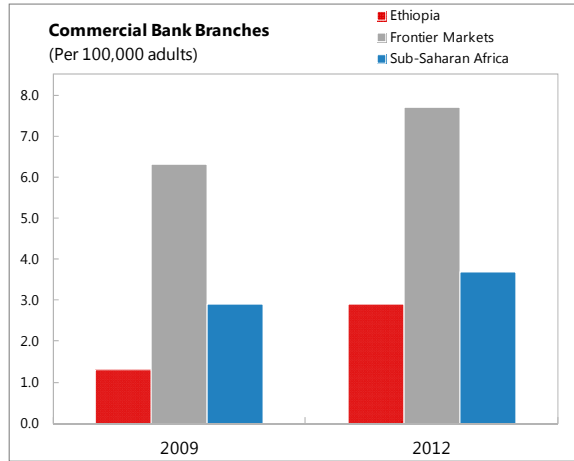
41. Banks are tapping to new areas of electronic and mobile banking to increase profitability and maintain the market share. The initial focus of this expansion is on further deposit mobilization as opposed to money transfer and other transactions. The microfinance sector appears to be growing rapidly, and staff stressed that its development remains a critical for providing credit to rural and low-income population as well as to small and medium enterprises. Ethiopia lags significantly behind the other SSA countries in all measures of financial access, including number of branches, ATMs, depositors and creditors (Figure 7). Staff encouraged the authorities to further incubate technology based extension of financial services to promote financial inclusion. In addition, Ethiopia significantly upgraded its anti-money laundering and combating the financing of terrorism (AML/CFT) regime, and is no longer blacklisted by the Financial Action Task Force (FATF). However, it remains under monitoring until completion of the action plan agreed with the FATF, and further implementation of the AML/CFT framework, in line with the findings from the ongoing World Bank's assessment, would assist sustainable financial development.

42. The financial soundness indicators (FSIs) do not indicate immediate risks to the health of the banking sector. Although FSIs based on aggregated information can mask potential vulnerabilities in individual banks, on average the banks appear to be well-capitalized and profitable. The system-wide capital adequacy ratio stood at a comfortable 17.5 percent at the end of March 2014, as opposed to the 8 percent minimum required. Return on assets and return on equity showed comfortable performance, at 3.1 percent and 44.6 percent, respectively. Asset quality has also improved over time, with nonperforming loans at less than 3 percent of banks' total loan portfolio at the end of March 2014. On the other hand, banks' operating costs appear to have increased and their liquidity buffers have shrunk. At the end of March 2014, the system-wide liquidity ratio was only slightly above the 15 percent minimum requirement.

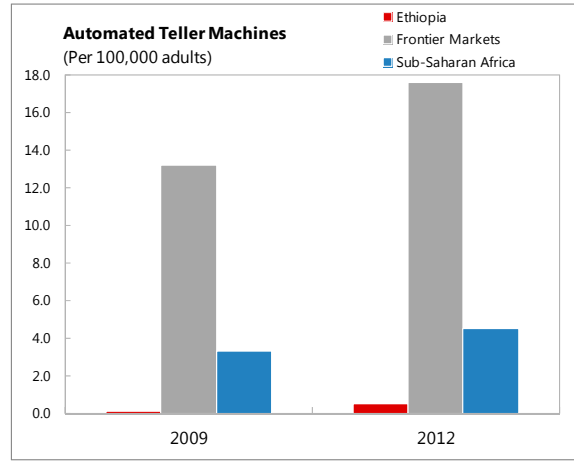
43. Notwithstanding the satisfactory FSIs, the systemic importance of the CBE is growing with its role in mobilizing the resources and financing the public sector investment program. Concentration of the CBE's large exposures to single entities warrants careful supervision and oversight by the NBE, with rigorous application of regulations limiting loans to related parties and a single borrower. Appropriate oversight and monitoring of the DBE's exposures and asset quality is also important in order to address any emerging problems.

Figure 7. Ethiopia: Financial Inclusiveness

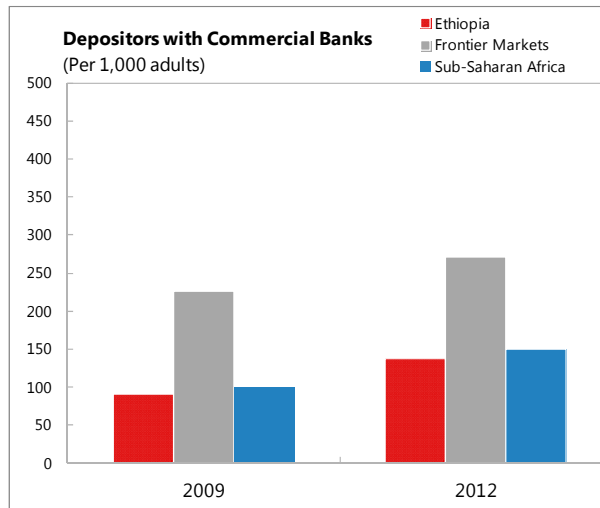
Despite rapid growth of bank branches, the number of banks per 100 thousand adults lags other SSA countries...



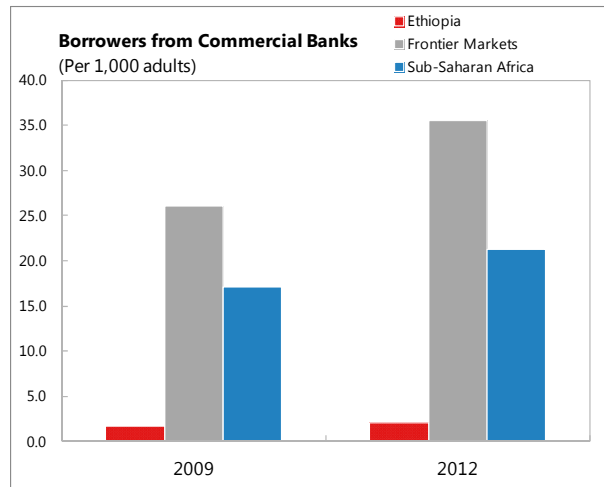
...while the access to bank accounts through ATMs remaining extremely limited.



The number of depositors continues to increase, as banks embarked on ambitious plan to mobilize domestic savings...



... but access to credit remains severely constrained, with large portion allocated to large state-owned enterprises.



Source: World Development Indicators

Authorities' views

44. The authorities expressed their confidence that banks remain in good health and are well-capitalized. The NBE is vigilant in taking actions to mitigate any risks that would emerge. It has adopted risk-based supervision and conducts regular on-site examinations, as well as off-site analysis of credit and liquidity risks. Implementation of the World Bank's financial sector capacity building recommendations is in progress. Similarly, they recognized the importance of further capacity building in the area of financial stability reporting and are eager to develop a framework for crisis preparedness and management. They pointed to their efforts towards further savings

mobilization through various saving schemes and indicated that they were considering measures to promote consolidation of private banks and scale of operations that could meet the borrowing needs of businesses. Regarding AML/CFT, they indicated that they have strengthened their Financial Intelligence Unit and issued relevant directives. The authorities are currently undergoing an assessment conducted by the World Bank against the 2012 revised FATF Standard.⁹

E. External Sector

45. Staff estimates the real effective exchange rate to be overvalued by 10–13 percent. The assessment is based on analyses of the macroeconomic balance, the equilibrium REER, and external sustainability (Annex I). The current account deficit in 2013/14 is estimated at some 7.1 percent of GDP and is expected to shrink to 5.0 percent of GDP in the next five years. At the same time, imports are forecast to remain high over the medium-term, mostly on account of petroleum products and construction equipment. This indicates that a depreciation of around 10 percent in the REER would be needed to close the projected current account gap.

46. Foreign exchange reserves cushion is thin and given the weak export performance building it up remains a challenge. Reserves are estimated to reach US\$2.8 billion by the end of 2013/14, covering only about 1.9 months of prospective imports, and have fluctuated around that level for most of FY2013/14. Given the relatively high level of imports expected in the coming years, further accumulation of reserves would be needed to improve the import coverage and build a buffer to respond to terms of trade shocks. Staff supported the NBE's objective of increasing foreign exchange reserves by US\$300 million by the end of 2014/15 and further to the equivalent of 3 months of imports over the medium term. The economy is dependent on agricultural commodity exports and imported fuel and capital goods and remains vulnerable to potential terms-of-trade shocks. Higher accumulation of international reserves in the coming years is therefore desirable to cope with shocks (Annex II).

Authorities' views

47. Authorities acknowledge that a competitive exchange rate is important but consider too rapid an adjustment to be counter-productive due to feedback effects on inflation. They preferred to effect the real effective exchange rate adjustment through a combination of gradual nominal exchange rate depreciation, further reduction in inflation and improved productivity of exports. They also indicated their commitment to addressing the chronically low level of international reserves. Efforts to promote non-traditional exports and exports of services along with those to attract fresh financing from abroad were expected to help in this regard.

⁹ The assessment is scheduled for discussion at the April 2015 Eastern and Southern Africa Anti-Money Laundering Group (ESAAMLG) Plenary, the FATF-style regional body of which Ethiopia is a member.

PROMOTING COMPETITIVENESS AND SUSTAINING LONG-TERM GROWTH

48. Despite substantial investment in key industries, structural transformation of Ethiopian economy remains a distant goal. Pronounced sectoral reallocation from agriculture to manufacturing with greater share of employment in industry has typically characterized countries transitioning from low- to middle-income. Ethiopia's GTP envisions an increase in the share of the industrial sector from 12.9 to 18.8 percent of GDP, implying an average annual growth rate of the industrial sector of some 20 percent. The actual realization thus far has fallen short of this. While the composition of output and employment is shifting away from agriculture, in Ethiopia's case, this is largely toward services, especially with respect to employment (Figure 8). More dynamic structural transformation remains key to achieving the ambitious growth and employment objectives of the GTP and beyond.

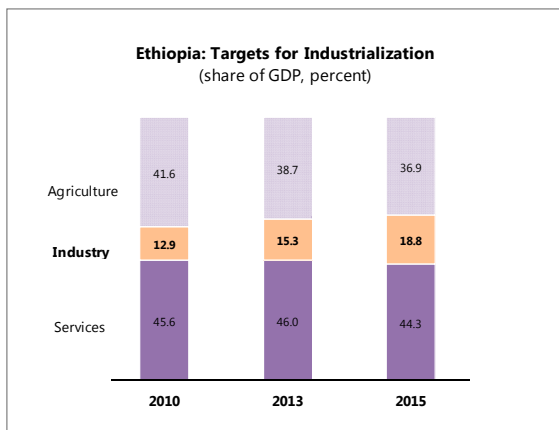
49. Ethiopia's global competitiveness suffers from weak export productivity. A key factor is trade costs where Ethiopia lags substantially behind its peers. Based on the World Bank's Logistics Performance Index—which measures the efficacy of a country's logistics based on efficiency of customs clearance process, quality of trade and transport-related infrastructure, ease of arranging competitive shipments in terms of price, quality of logistics services, ability to track and trace consignments, and frequency with which shipments reach the consignee within the scheduled time—, Ethiopia ranks at the lower end of the surveyed countries in all the six key dimensions of logistics covered by the index.

50. The shift towards manufacturing and export oriented activities is proceeding slowly. Factors hampering progress include, limited capacity and inadequate leveraging of the private sector, weak business climate, including higher trade barriers, insufficient incentives for, and sensitivity of, domestic savings—characterized by negative real rates of interest, limited range of financial instruments, and an underdeveloped financial system.

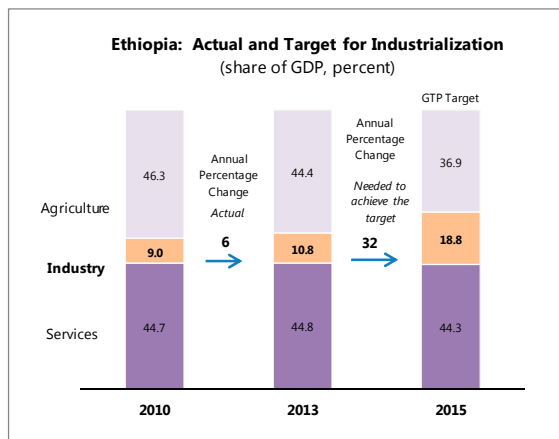
51. Adapting policies to provide greater scope for the private sector will be important going forward. In the context of the next five year plan (GTP II), consideration should be given to greater reliance on the private sector not only to contribute to the investment effort, but also to improve the country's competitiveness. Industrial sector development is crucial for the transition from low- to middle-income economy. Structural change, shifting resources—especially labor—away from agriculture to industry and services would need to capitalize on the private sector's power to perceive opportunity, startup business, and create new products (Box 2).

Figure 8. Ethiopia: Structural Transformation

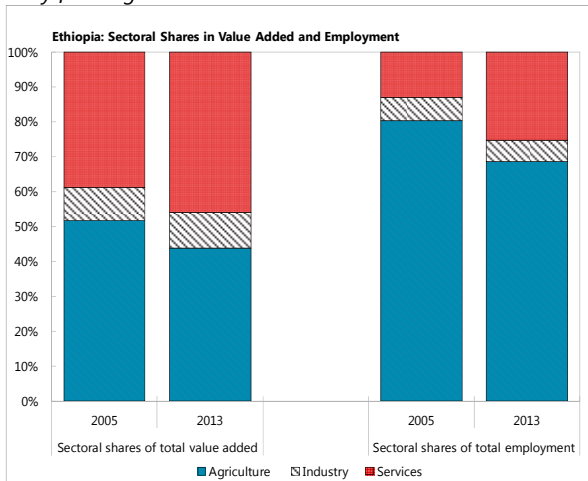
Ethiopia has ambitious targets for industrialization...



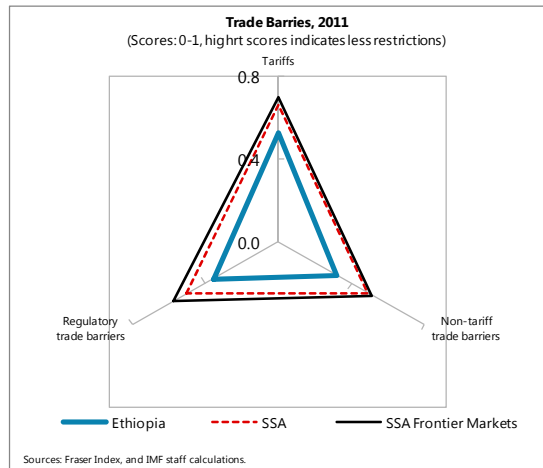
...but the actual performance falls short.



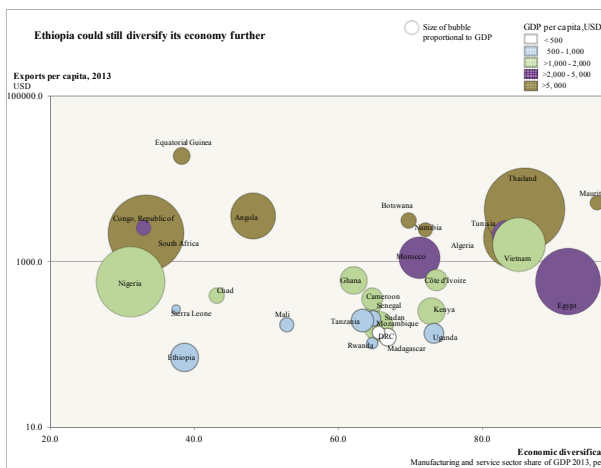
The composition of output and employment is shifting away from agriculture toward services.



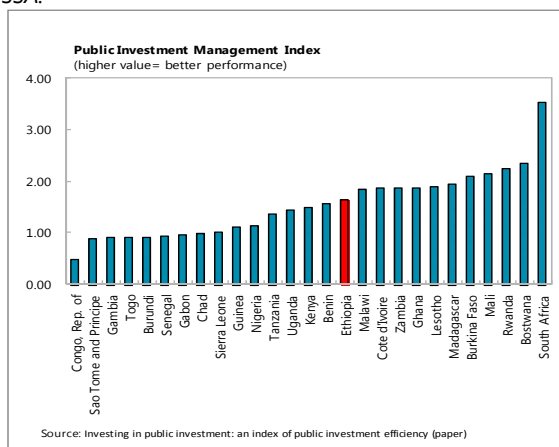
Trade Barriers are more pronounced in Ethiopia than in other SSA.



Ethiopia is yet to be one of the most diversified SSA economies...



...with quality of public investment planning and management placing the country above the median in SSA.



Sources: Growth and Transformation Plan, GTP, and ILO

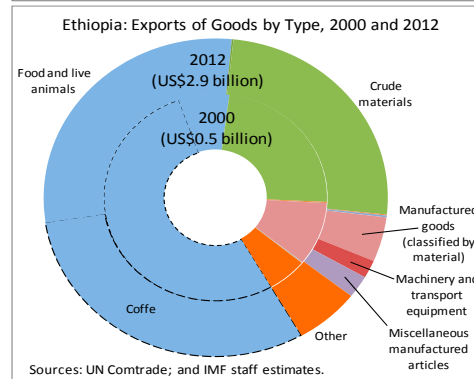
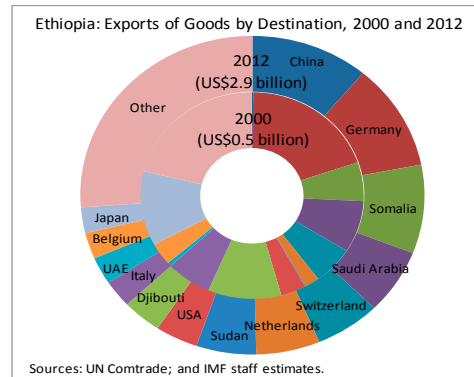
Box 3. Ethiopia: Export Competitiveness and Diversification

Ethiopia has experienced significant structural changes in the external sector in the last decade. Exports have increased six-fold since 2000 and new markets have opened for Ethiopian products. Exports are now reaching a larger number of destinations (including China).

Based on UN Comtrade SITC classification, at the most aggregated level, Ethiopian exports continue to be dominated by basic commodities, but share of coffee in total exports has shrunk from 53 to 31 percent during 2000–12, even as value increased 250 percent in dollar terms. Exports showing remarkable performance in recent years are sesame and oil seeds, flowers, leather, gold and aircraft equipment.

Non-coffee goods exports are only about 5.5 percent of GDP in 2013 and hence still low in terms of contribution to economic growth.

Nonfactor services have accounted for an average of 7 percent of GDP in the past 12 years. The ongoing expansion of Ethiopian Airlines is expected to further increase the share of services in the export sector. Also, potential exports of electricity to neighboring countries as generation and distribution projects come on stream, can transform the role of international trade in economic growth and employment in the country.



52. Harnessing entrepreneurship can be helpful in transitioning from a factor-driven toward an innovation-driven economy.¹⁰ On the 2014 Global Entrepreneurship and Development Index, which captures the contextual features of entrepreneurship across individual and institutional variables, Ethiopia ranks 111 out of 121 countries. The very low score reflects major obstacles to entrepreneurship in the country.

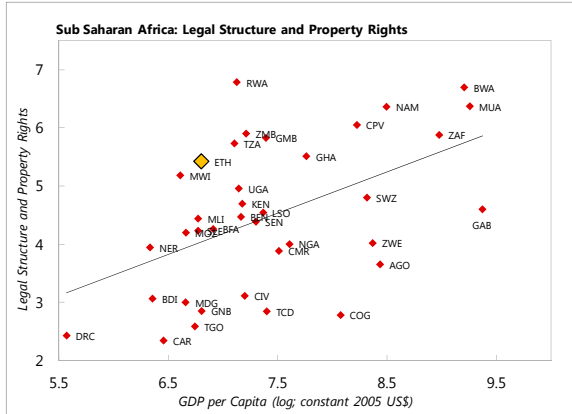
53. Efforts to create a business-friendly environment should be pushed aggressively to give confidence to the private sector. Although Ethiopia ranks better in the quality of legal system and property rights than the median SSA countries, the regulation and administrative requirements are major hurdles for businesses. In 2013/14 cost of starting business in Ethiopia was twice higher than in SSA frontier markets and about 30 percent higher than in median SSA (Figure 9).¹¹ Reducing regulatory and administrative burdens, which hamper entry and exit of firms, while promoting entrepreneurship, level playing field, vigorous competition and adequate protection of investors, are crucial.

¹⁰ See also the accompanying Selected Issues paper.

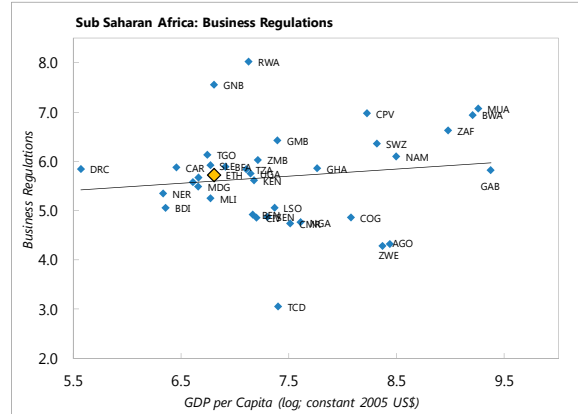
¹¹ See "Doing Business 2014", the World Bank Group, 2014.

Figure 9. Ethiopia: Business Environment

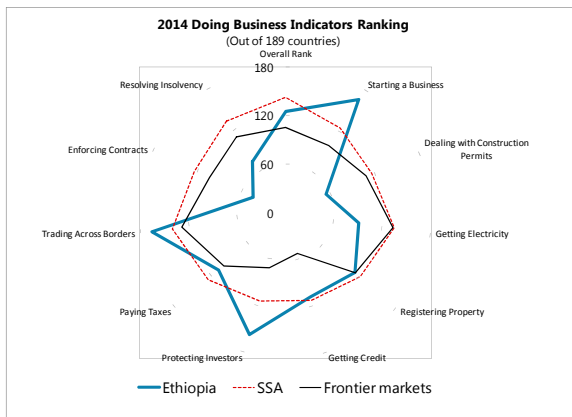
Ethiopia ranks better in the quality of legal system and property rights...



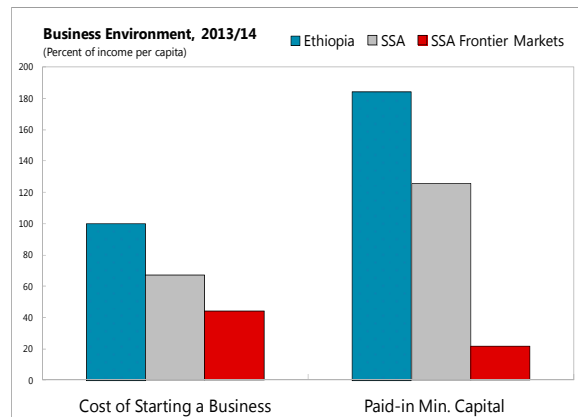
...while the overall business environment; including regulations and administrative burdens indicates weaknesses.



Doing Business Indicators point to improvements in a number of areas (e.g., enforcing contracts and dealing with construction permits)...



...but cost of starting business and paid-in minimum capital remain particularly high discouraging private sector investment.



Sources: Doing Business (WB) and Fraser Database.¹

¹ Doing Business Indicators should be interpreted with caution due to a limited number of respondents, limited geographical coverage, and standardized assumptions on business constraints and information availability.

54. Opening up some key sectors to the private sector and FDI can be beneficial. While the government can retain control in some strategic sectors—such as power generation and defense industry—opening up others would broaden business opportunities for private sector as well as improve efficiency in the liberalized sectors. For example, opening up the telecommunication sector, the transport and trade logistics, as well as the sugar industry to private investors (including foreign investors) can help to develop these sectors and improve their efficiency and quality of services and products. The banking sector should also be open to foreign investors to enhance competition, lower market concentration, and accelerate the process of adopting new technologies in delivering financial services.

Authorities' views

55. The authorities acknowledged the structural problems affecting competitiveness and highlighted the focus on infrastructure, which they expected would boost competitiveness of the traded goods sector. Prospects for exports are being enhanced by efforts to attract FDI and private investors' participation in export oriented economic activities. Efforts to promote non-traditional exports have also produced some results, with coffee representing a shrinking share of total exports and exports of services growing fast as a result of the expansion of Ethiopian Airlines operations. They also agreed with the staff's view on the role of the private sector and indicated that they are already undertaking some of the actions that staff is recommending, with the exception of opening up of strategic sectors to the private sector.

OTHER ISSUES

56. Data provision is adequate for surveillance. However, reflecting capacity constraints available statistics are subject to significant weaknesses and delays. National account statistics need improvement, especially on the expenditure side, notwithstanding the authorities' efforts to strengthen their compilation. As a result, official figures on economic growth, saving and investment are subject to a wide range of uncertainty. Staff stressed the need to improve national accounts compilation and urged the authorities to continue to avail themselves of technical assistance and implement its recommendations. The authorities also do not provide detailed information on the financial sector, including commercial banks' income statements, distribution of non-performing loans across banks, and maturity structure of credit and net open positions of banks, to the Fund. Comprehensive data on the financial positions of public enterprises are lacking and hamper the proper assessment of their borrowing and capacity to repay. Compilation of export and import of services in the balance of payments based on the new methodology suffers from shortage of staff and a low response rate from information providers. Reporting of high frequency data to the Fund on a regular basis are also subject to significant delays.

57. Ethiopia has yet to move to Article VIII status and maintains exchange restrictions on payments and transfers for current international transactions that are not consistent with Article VIII.¹² At present, there are four restrictions on the payments and transfers for current international transactions, which relate to: (i) the tax certification requirement for repatriation of dividend and other investment income; (ii) restrictions on repayment of legal external loans and supplies and foreign partner credits; (iii) rules for issuance of import permits by commercial banks; and (iv) the requirement to provide a clearance certificate from NBE to obtain import permits.

58. WTO accession negotiations are continuing. Since the submission of the Memorandum of Foreign Trade Regime in 2006, three rounds of Working Party meetings have taken place. A number of documents were prepared for submission to the Secretariat for the fourth Working party meeting,

¹² See 2014 Article IV consultation Informational Annex.

including revised legislative action plan, revised “goods” offer, and information on import licensing. Outstanding issues relate to domestic market access, state trading regime, and customs valuation practices. The authorities intended to join the WTO before end-2014/15, but the timetable may be postponed.

Authorities’ views

59. The authorities stressed that they are continuing their efforts to enhance their statistical capacities. They were seeking to improve national account and other statistics with technical assistance from East AFRITAC and looked forward to continued technical assistance in this area. They cited confidentiality reasons for not sharing bank-by-bank information with the mission.

STAFF APPRAISAL

60. Ethiopia’s developmental strategy continues to yield positive results. The authorities should be commended for delivering robust economic growth, generating employment, and improving social indicators. These outcomes have been realized in the context of broad macroeconomic stability, with inflation in single digits and restrained monetary policy and fiscal policy at the general government level, although public enterprises continue to provide expansionary impulse.

61. A key role has been played by proactive public policy that is focused on the real sector and implemented through public enterprises but this entails risks. Although the budgetary stance at the general government level has been cautious, staff urges the authorities to curtail domestic borrowing by public enterprises and carefully monitor the operations of the overall public sector in order to establish a robust fiscal anchor. In particular, there is a need to closely track the financial position of public enterprises, prioritize and gradually phase-in their investments, carefully assess their macroeconomic impact, including crowding-out of private sector investment, and limit the potential for creating contingent liabilities. Staff supports the authorities’ intention to establish a high level mechanism to comprehensively oversee public enterprises. Staff also urges the authorities to maintain prudent overall borrowing levels in the context of a medium-term debt management strategy.

62. Maintaining inflation in single digits should remain the main focus of NBE. This calls for continued restrained monetary stance, since inflation remains in the upper end of the authorities’ target with non-food prices stubbornly in double digits. Monetary policy will need to remain vigilant against the impact of volatile food and energy prices, and domestic demand pressures, including the risk of increased inflationary pressures from the large domestically financed investment projects. It would also need to be supported by appropriately restrained recourse to NBE for financing the budget.

63. Staff considers the time to be appropriate for greater flexibility in nominal interest rates and measures for money market development. The NBE should focus on using indirect instruments of monetary policy for achieving monetary targets. Flexibility of nominal interest rates is precondition for making T-bills an effective instrument for liquidity management and reviving government securities market. This should also have a positive impact on mobilization of domestic saving for financing large-scale investment program.

64. Phasing out the requirement for commercial banks to hold NBE bills would help improve the uneven playing field between public and private banks. This remains a distorting measure that adversely impacts the cost and quantity of private sector credit provided by commercial banks, notwithstanding their current high profitability. The requirement is intended to fund DBE lending to the private sector, which should be accomplished through more direct funding to DBE.

65. Staff's analysis indicates that the real effective exchange rate is overvalued and an important factor in the recent weak export performance. Allowing more market-based movement of exchange rate with a view toward restoring competitiveness and further narrowing spread between the parallel and official foreign exchange markets is needed and would contribute to a stronger balance of payments. Staff supports the authorities' objective of accumulating foreign exchange reserves to three months of imports and would recommend a less drawn out timeframe for doing so in order to build resiliency to shocks.

66. In light of the large financing need in the GTP, staff urges the authorities to shift the balance toward the private sector as an engine of growth. Development of a strong and vibrant private sector is essential to sustain growth over the long-run and requires fostering competition in areas where public enterprises enjoy monopolies, gradually withdrawing from areas, where they crowd-out the private sector, and fully corporatizing and orienting outward through foreign partnerships those that remain. Foreign direct investment should also be further encouraged by reducing bureaucratic red tape and improving the overall business climate, including ease of access to credit and foreign exchange for the private sector. A reorientation along these lines is critical for achieving the higher growth projections set out in the staff's alternative scenario.

67. Staff underscores the need for continued improvements in data quality. There are significant weaknesses in national accounts statistics and information gaps on the financial sector. Availability of timely and comprehensive information on financial performance and borrowing requirements of public enterprises is important for a proper assessment of public sector finances.

68. Staff recommends that the next Article IV consultation with Ethiopia be held on the 12-month consultation cycle. This is in accordance with the decision on consultation cycles, Decision No. 14747-(10/96) (9/28/2010).

Table 2. Ethiopia: Selected Economic and Financial Indicators, 2011/12–2018/19¹

	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19
	Act.	Act	Est.	Proj.	Proj.	Proj.	Proj.	Proj.
(Annual percentage change)								
National income and prices								
GDP at constant prices (at factor cost)	8.8	9.7	8.2	8.5	8.5	8.0	8.0	7.5
GDP deflator	34.3	4.6	7.3	9.1	9.0	9.3	9.4	9.2
Consumer prices (period average)	34.1	13.5	8.1	8.2	9.0	9.0	9.0	9.0
Consumer prices (end period)	20.7	7.4	8.5	9.0	9.0	9.0	9.0	9.0
External sector								
Exports (U.S. dollars, f.o.b.)	14.8	-2.6	9.1	15.0	16.5	15.3	14.1	14.2
Imports (U.S. dollars, c.i.f.)	33.5	4.1	12.7	17.0	9.5	7.5	11.1	9.7
Export volume	-0.2	9.4	14.7	9.4	17.5	14.2	12.0	13.2
Import volume	24.5	4.3	13.3	17.4	11.2	8.7	11.6	10.0
Terms of trade (deterioration –)	7.2	-11.9	-5.0	5.9	0.5	2.2	2.6	1.3
Nominal effective exchange rate (end of period)	2.8	-5.2	...	...	...	...	...	...
Real effective exchange rate (end of period)	19.7	-1.1	...	...	...	...	...	...
(Percent of beginning-period stock of broad money, unless otherwise indicated)								
Money and credit								
Net foreign assets	-11.6	3.1	-0.5	2.7	3.0	3.4	3.9	4.9
Net domestic assets (including other items net)	44.5	21.0	25.6	20.3	17.0	16.1	15.7	14.6
Broad money	32.9	24.1	25.1	23.0	20.0	19.5	19.6	19.5
Base money (annual percentage change)	0.4	13.6	16.7	18.7	18.3	18.1	18.3	17.6
Velocity (GDP/broad money)	3.91	3.64	3.39	3.28	3.23	3.19	3.16	3.11
(Percent of GDP, unless otherwise indicated)								
Financial balances								
Gross domestic savings	15.0	16.0	12.8	10.9	11.2	11.9	11.9	12.1
Public savings	5.7	5.8	3.3	2.6	2.8	3.1	3.7	4.0
Private savings	9.3	10.2	9.5	8.4	8.4	8.8	8.2	8.1
Gross domestic investment	33.1	33.0	30.2	29.1	28.2	27.4	26.8	26.3
Public investment	25.0	24.6	21.7	20.5	19.8	19.1	18.5	18.2
Private investment	8.0	8.4	8.5	8.6	8.4	8.3	8.2	8.0
Resource gap	-18.1	-17.0	-17.4	-18.2	-17.0	-15.5	-14.9	-14.2
External current account balance, including official transfers	-6.5	-6.0	-7.1	-7.3	-6.7	-5.8	-5.5	-5.0
Government finances								
Revenue	13.9	14.6	14.1	14.5	14.5	14.5	14.6	14.8
Tax revenue	11.6	12.5	13.0	13.3	13.3	13.3	13.4	13.6
Nontax revenue	2.3	2.0	1.1	1.2	1.2	1.2	1.2	1.2
External grants	1.7	1.5	1.6	1.5	1.3	1.2	1.1	1.1
Expenditure and net lending	16.8	18.1	18.4	18.9	18.7	18.4	18.3	18.3
Fiscal balance, excluding grants (cash basis)	-2.9	-3.5	-4.3	-4.4	-4.2	-3.9	-3.7	-3.6
Fiscal balance, including grants (cash basis)	-1.2	-2.0	-2.7	-3.0	-2.9	-2.7	-2.6	-2.5
Total financing (including residuals)	1.2	2.0	2.7	3.0	2.9	2.7	2.6	2.5
External financing	0.9	2.0	1.5	1.4	1.2	1.1	1.0	0.9
Domestic financing (not including privatization)	0.5	0.2	1.2	1.6	1.6	1.6	1.6	1.6
Public debt ²	32.7	37.4	44.7	50.6	54.3	56.4	56.7	56.0
Domestic debt	14.8	16.9	22.2	24.1	25.4	26.5	27.8	28.3
External debt (including to the IMF)	17.9	20.5	22.6	26.5	28.9	29.9	28.8	27.7
Overall balance of payments (in millions of U.S. dollars)	-1067	338	-57	300	400	535	697	995
Gross official reserves (in millions of U.S. dollars)	2,262	2,368	2,761	3,061	3,461	3,996	4,693	5,688
(months of imports of goods and nonfactor services of following year)	2.0	1.9	1.9	1.9	2.0	2.1	2.2	2.6
GDP at current market prices (billions of birr)	739	853	995	1,181	1,397	1,650	1,952	2,295

Sources: Ethiopian authorities and IMF staff estimates and projections.

¹ Data pertain to Ethiopian fiscal year from July 8 to July 7.² Public debt includes general government and state own enterprises (Excluding Ethiopian Airlines).

Table 3a. Ethiopia: General Government Operations, 2011/12–2018/19¹
(millions of birr)

	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19
	Act.	Act.	Est.	Proj.	Proj.	Proj.	Proj.	Proj.
Total revenue and grants	115,659	137,192	156,344	188,283	221,185	258,074	305,930	362,995
Revenue	102,864	124,077	140,536	171,012	202,874	238,984	285,184	338,602
Tax revenue	85,740	107,010	129,325	157,171	186,498	219,651	262,308	311,705
Direct taxes	28,858	36,393	42,456	50,401	59,635	70,405	83,305	97,947
Indirect taxes	56,882	70,618	86,870	106,770	126,864	149,247	179,004	213,758
Domestic indirect taxes	23,326	32,440	37,845	44,928	53,158	62,759	74,258	87,310
Import duties and taxes	33,556	38,177	49,024	61,842	73,705	86,487	104,745	126,447
Nontax revenue	17,124	17,067	11,212	13,841	16,376	19,334	22,876	26,897
Grants	12,795	13,115	15,808	17,271	18,311	19,090	20,746	24,393
Program grants ²	4,706	3,416	4,022	4,775	5,649	6,670	7,892	9,279
Project grants	8,089	9,699	11,786	12,496	12,661	12,420	12,854	15,114
Total expenditure and net lending (cash basis) ³	124,417	153,965	183,431	223,374	261,247	303,047	356,925	420,535
Recurrent expenditure ³	51,445	62,782	73,529	87,557	103,686	122,243	140,496	165,696
Defense spending	6,486	6,493	7,500	8,000	8,500	8,500	10,057	11,825
Poverty-reducing expenditure ⁴	24,994	31,481	36,725	43,599	51,585	60,902	72,061	84,727
Interest payments	2,230	2,931	3,782	5,660	7,752	10,518	13,308	16,151
Domestic interest and charges	1,388	1,792	2,129	3,437	5,347	7,931	10,593	13,029
External interest payments ⁵	842	1,139	1,653	2,223	2,405	2,587	2,715	3,122
Other recurrent expenditure	17,735	21,877	25,522	30,298	35,848	42,323	45,070	52,992
Capital expenditure	72,971	91,183	109,902	135,817	157,561	180,804	216,429	254,839
Central treasury	57,439	68,552	87,079	111,571	132,627	155,948	190,685	227,279
External project grants	8,089	9,699	11,786	12,496	12,661	12,420	12,854	15,114
External project loans	7,443	12,933	11,037	11,749	12,272	12,436	12,890	12,446
Of which: poverty-reducing expenditure ⁴	62,574	76,334	89,686	106,112	125,498	148,216	175,134	205,593
Overall balance								
Including grants	-8,758	-16,772	-27,087	-35,091	-40,062	-44,973	-50,995	-57,540
Excluding grants	-21,553	-29,888	-42,895	-52,362	-58,373	-64,063	-71,742	-81,933
Financing	13,087	19,810	27,087	35,091	40,062	44,973	50,995	57,540
Net external financing	6,530	16,846	14,865	16,182	17,314	18,117	19,218	19,718
Gross borrowing	7,443	17,965	16,479	17,457	19,026	20,409	22,324	23,538
Project loans	7,443	12,933	11,037	11,749	12,272	12,436	12,890	12,446
Protection of Basic Services (PBS)	0	5,032	5,442	5,708	6,753	7,973	9,434	11,092
Amortization ⁵	-1,063	-1,281	-1,614	-1,275	-1,712	-2,292	-3,106	-3,820
Total net domestic financing	3,793	1,764	12,222	18,909	22,748	26,857	31,777	37,822
Privatization	2,764	1,200	0	0	0	0	0	0
<i>Memorandum items:</i>								
Poverty-reducing expenditure	87,568	107,815	126,411	149,711	177,083	209,118	247,195	290,320
Primary fiscal balance, including grants	-6,528	-13,841	-23,305	-29,431	-32,310	-34,455	-37,687	-41,389
Domestic fiscal balance, including grants	-5,178	-6,117	-18,419	-25,893	-31,034	-36,620	-43,283	-51,251
Gross domestic government debt	57,053	58,817	71,039	89,948	112,696	139,552	171,330	209,152

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

¹ Government financial statistics are reported by the authorities based on GFSM 1986.

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

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 after HIPC debt relief from the World Bank and African Development Bank.

Table 3b. Ethiopia: General Government Operations, 2011/12–2018/19
(percent of GDP)

	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19
	Act.	Act.	Est.	Proj.	Proj.	Proj.	Proj.	Proj.
Total revenue and grants	15.7	16.1	15.7	15.9	15.8	15.6	15.7	15.8
Revenue	13.9	14.6	14.1	14.5	14.5	14.5	14.6	14.8
Tax revenue	11.6	12.5	13.0	13.3	13.3	13.3	13.4	13.6
Direct taxes	3.9	4.3	4.3	4.3	4.3	4.3	4.3	4.3
Indirect taxes	7.7	8.3	8.7	9.0	9.1	9.0	9.2	9.3
Domestic indirect taxes	3.2	3.8	3.8	3.8	3.8	3.8	3.8	3.8
Import duties and taxes	4.5	4.5	4.9	5.2	5.3	5.2	5.4	5.5
Nontax revenue	2.3	2.0	1.1	1.2	1.2	1.2	1.2	1.2
Grants	1.7	1.5	1.6	1.5	1.3	1.2	1.1	1.1
Emergency assistance (food and nonfood aid)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Program grants ¹	0.6	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Project grants	1.1	1.1	1.2	1.1	0.9	0.8	0.7	0.7
Total expenditure and net lending (cash basis) ²	16.8	18.1	18.4	18.9	18.7	18.4	18.3	18.3
Recurrent expenditure ²	7.0	7.4	7.4	7.4	7.4	7.4	7.2	7.2
Defense spending	0.9	0.8	0.8	0.7	0.6	0.5	0.5	0.5
Poverty-reducing expenditure ³	3.4	3.7	3.7	3.7	3.7	3.7	3.7	3.7
Interest payments	0.3	0.3	0.4	0.5	0.6	0.6	0.7	0.7
Domestic interest and charges	0.2	0.2	0.2	0.3	0.4	0.5	0.5	0.6
External interest payments ⁴	0.1	0.1	0.2	0.2	0.2	0.2	0.1	0.1
Emergency assistance (food and other emergency aid)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other recurrent expenditure	2.4	2.6	2.6	2.6	2.6	2.6	2.3	2.3
Capital expenditure	9.9	10.7	11.0	11.5	11.3	11.0	11.1	11.1
Central treasury	7.8	8.0	8.8	9.4	9.5	9.5	9.8	9.9
External project grants	1.1	1.1	1.2	1.1	0.9	0.8	0.7	0.7
External project loans	1.0	1.5	1.1	1.0	0.9	0.8	0.7	0.5
Of which: poverty-reducing expenditure ³	8.5	9.0	9.0	9.0	9.0	9.0	9.0	9.0
Overall balance								
Including grants	-1.2	-2.0	-2.7	-3.0	-2.9	-2.7	-2.6	-2.5
Excluding grants	-2.9	-3.5	-4.3	-4.4	-4.2	-3.9	-3.7	-3.6
Financing	1.8	2.3	2.7	3.0	2.9	2.7	2.6	2.5
Net external financing	0.9	2.0	1.5	1.4	1.2	1.1	1.0	0.9
Gross borrowing	1.0	2.1	1.7	1.5	1.4	1.2	1.1	1.0
Project loans	1.0	1.5	1.1	1.0	0.9	0.8	0.7	0.5
Protection of Basic Services (PBS)	0.0	0.6	0.5	0.5	0.5	0.5	0.5	0.5
Amortization ⁴	-0.1	-0.2	-0.2	-0.1	-0.1	-0.1	-0.2	-0.2
Total net domestic financing	0.5	0.2	1.2	1.6	1.6	1.6	1.6	1.6
Privatization	0.4	0.1	0.0	0.0	0.0	0.0	0.0	0.0
<i>Memorandum items:</i>								
Poverty-reducing expenditure	11.9	12.6	12.7	12.7	12.7	12.7	12.7	12.6
Primary fiscal balance, including grants	-0.9	-1.6	-2.3	-2.5	-2.3	-2.1	-1.9	-1.8
Domestic fiscal balance, including grants	-0.7	-0.7	-1.9	-2.2	-2.2	-2.2	-2.2	-2.2
Gross domestic government debt	7.7	6.9	7.1	7.6	8.1	8.5	8.8	9.1

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 Excluding special programs (demobilization and reconstruction).

³ Poverty-reducing spending is defined to include total spending on health, education, agriculture, roads, and food security.

⁴ External interest and amortization are presented after HIPC debt relief from the World Bank and African Development Bank.

Table 4. Ethiopia: Monetary Survey and Central Bank Accounts, 2011/12–2018/19¹

	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19
	Act.	Act.	Est.	Proj.	Proj.	Proj.	Proj.	Proj.
(Millions of birr)								
Monetary survey								
Net foreign assets	39,788	45,649	44,475	52,297	63,036	77,948	98,297	128,711
Central bank	21,254	24,646	27,611	34,252	43,727	57,288	76,191	105,058
Commercial banks	18,533	21,003	16,865	18,045	19,309	20,660	22,106	23,654
Net domestic assets	149,051	188,685	248,676	308,279	369,658	439,124	520,120	610,297
Domestic credit	189,080	233,311	302,850	370,376	440,342	523,310	630,455	735,300
Claims on government (net) ²	21,571	21,965	31,103	44,017	59,673	78,157	100,027	126,200
Claims on nongovernment	167,510	211,346	271,748	326,359	380,669	445,153	530,428	609,100
Public enterprises	98,897	135,412	183,265	228,253	276,516	332,259	405,986	473,511
Private sector	68,613	75,934	88,483	98,105	104,153	112,893	124,441	135,589
Other items (net)	-40,030	-44,627	-54,174	-62,097	-70,684	-84,186	-110,334	-125,003
Broad money	188,838	234,333	293,151	360,576	432,694	517,071	618,417	739,009
Money	94,280	113,764	145,987	182,656	222,205	269,309	324,081	392,462
Currency outside banks	38,537	45,432	52,111	60,813	70,118	82,809	97,963	115,205
Demand deposits	55,743	68,332	93,876	121,842	152,087	186,499	226,118	277,257
Quasi money	94,558	120,569	147,164	177,921	210,489	247,763	294,336	346,546
Savings deposits	82,489	106,277	137,009	165,292	195,214	229,468	272,410	320,266
Time deposits	12,070	14,292	10,155	12,629	15,275	18,295	21,926	26,280
Central bank								
Net foreign assets	21,254	24,646	27,611	34,252	43,727	57,288	76,191	105,058
Foreign assets	40,101	44,140	52,277	58,919	68,394	81,955	100,858	129,725
Foreign liabilities	18,847	19,494	24,667	24,667	24,667	24,667	24,667	24,667
Net domestic assets	44,718	50,297	59,847	69,560	79,083	87,751	95,390	96,721
Domestic credit	57,846	71,884	83,884	96,884	111,884	128,884	155,884	171,884
Government (net)	45,344	55,377	67,377	80,377	95,377	112,377	139,377	155,377
Other items (net)	-13,128	-21,588	-24,037	-27,324	-32,802	-41,133	-60,494	-75,163
Base money	65,973	74,942	87,458	103,812	122,810	145,038	171,581	201,779
Currency outside banks	38,537	45,432	52,111	60,813	70,118	82,809	97,963	115,205
Commercial bank reserves	27,435	29,510	35,347	42,999	52,692	62,229	73,617	86,574
Cash in vault	7,248	9,247	8,631	10,070	12,340	14,573	17,240	20,274
Reserve deposit	20,187	20,265	26,715	32,929	40,352	47,656	56,377	66,299
(Annual percentage change, unless otherwise indicated)								
Monetary survey								
Net foreign assets	-29.3	14.7	-2.6	17.6	20.5	23.7	26.1	30.9
Net domestic assets	73.6	26.6	31.8	24.0	19.9	18.8	18.4	17.3
Domestic credit	36.3	23.4	29.8	22.3	18.9	18.8	20.5	16.6
Claims on government (net)	-31.9	1.8	41.6	41.5	35.6	31.0	28.0	26.2
Claims on nongovernment	56.5	26.2	28.6	20.1	16.6	16.9	19.2	14.8
Public enterprises	71.7	36.9	35.3	24.5	21.1	20.2	22.2	16.6
Private sector	38.8	10.7	16.5	10.9	6.2	8.4	10.2	9.0
Broad money	32.9	24.1	25.1	23.0	20.0	19.5	19.6	19.5
Money	29.2	20.7	28.3	25.1	21.7	21.2	20.3	21.1
Quasi money	36.8	27.5	22.1	20.9	18.3	17.7	18.8	17.7
Memorandum items:								
Base money growth	0.4	13.6	16.7	18.7	18.3	18.1	18.3	17.6
Excess reserve deposit (billions of birr)	3,722	10,011	13,948	17,225	21,508	25,227	29,639	34,394
Percent of deposits	2.3	4.9	5.5	5.5	5.9	5.8	5.7	5.5
Money multiplier (broad money/reserve money)	2.86	3.13	3.35	3.47	3.52	3.57	3.60	3.66
Velocity (GDP/broad money)	3.91	3.64	3.39	3.28	3.23	3.19	3.16	3.11
Currency-deposit ratio	0.256	0.241	0.216	0.203	0.193	0.191	0.188	0.185
Gross official foreign reserves (millions of U.S. dollars)	2,262	2,368	2,761	3,061	3,461	3,996	4,693	5,688
Birr per U.S. dollar (end of period)	17.77	18.54	...	...	...	...	...	...
Nominal GDP (millions of birr)	738,605	852,740	994,804	1,180,990	1,397,335	1,649,704	1,951,968	2,295,069

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

¹ Year ending July 7. Including commercial bank claims and liabilities to Eritrea. The columns for the authorities reflect NBE's estimates and targets for end-June.² Claims on the general government by the banking system less deposits of the general government with the banking system.

Table 5. Ethiopia: Balance of Payments, 2011/12–2018/19¹

	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19
	Act.	Act.	Est.	Proj.	Proj.	Proj.	Proj.	Proj.
(Millions of U.S. dollars, unless otherwise indicated)								
Current account balance	-2,757	-2,783	-3,534	-4,037	-4,071	-3,927	-4,101	-4,048
(Percent of GDP)	-6.5	-6.0	-7.1	-7.3	-6.7	-5.8	-5.5	-5.0
Current account balance, excl. official transfers	-4,545	-4,029	-4,855	-6,010	-6,216	-6,248	-6,619	-6,724
(Percent of GDP)	-10.7	-8.8	-9.8	-10.9	-10.2	-9.3	-8.9	-8.2
Trade balance	-7,865	-8,398	-9,570	-11,265	-12,072	-12,624	-13,861	-14,948
Exports of goods	3,153	3,070	3,351	3,852	4,488	5,173	5,904	6,744
Imports of goods	-11,018	-11,467	-12,921	-15,117	-16,560	-17,796	-19,765	-21,692
Services (net)	171	572	942	1,248	1,702	2,194	2,779	3,369
Exports	2,811	2,853	3,314	3,821	4,558	5,280	6,111	7,153
Imports	-2,639	-2,281	-2,372	-2,572	-2,856	-3,085	-3,333	-3,784
Income (net)	-96	-97	-142	-286	-365	-460	-500	-531
Private transfers (net)	3,246	3,894	3,916	4,293	4,519	4,641	4,963	5,385
Official transfers (net)	1,788	1,247	1,321	1,973	2,145	2,320	2,519	2,677
Capital account balance	2,243	3,050	3,639	4,337	4,471	4,462	4,798	5,043
Foreign direct investment (net)	1,072	1,232	1,355	1,833	2,853	2,752	3,089	4,263
Other investment (net) ²	1,171	1,818	2,284	2,504	1,617	1,710	1,708	780
Official long-term loans	1,292	1,003	1,720	2,504	1,617	1,710	1,708	780
Disbursements	1,605	1,669	2,641	3,682	2,873	3,061	3,179	2,601
Amortization	-313	-666	-921	-1,178	-1,256	-1,351	1,471	1,821
Errors and omissions	-553	71	-162	0	0	0	0	0
Overall balance	-1,067	338	-57	300	400	535	697	995
Financing	1,067	-338	57	-300	-400	-535	-697	-995
Central bank (net; increase –)	782	-106	-143	-300	-400	-535	-697	-995
Reserves (increase –)	782	-106	-393	-300	-400	-535	-697	-995
Liabilities (increase +)	0	0	250	0	0	0	0	0
Commercial banks (net; increase –)	285	-232	200	0	0	0	0	0
(Annual percentage change, unless otherwise indicated)								
<i>Memorandum items:</i>								
Exports of goods	14.8	-2.6	9.1	15.0	16.5	15.3	14.1	14.2
Export volume index	-0.2	9.4	14.7	9.4	17.5	14.2	12.0	13.2
Imports of goods	33.5	4.1	12.7	17.0	9.5	7.5	11.1	9.7
Import volume index	24.5	4.3	13.3	17.4	11.2	8.7	11.6	10.0
Services exports	8.7	1.5	16.1	15.3	19.3	15.8	15.8	17.0
Services imports	44.4	-13.6	4.0	8.5	11.0	8.0	8.0	13.5
Exports of goods and services (percent of GDP)	14.0	12.9	13.4	13.9	14.8	15.5	16.1	17.0
Imports of goods and services (percent of GDP)	-32.0	-29.9	-30.8	-32.1	-31.8	-31.0	-31.0	-31.2
Gross official reserves (millions U.S. dollars)	2,262	2,368	2,761	3,061	3,461	3,996	4,693	5,688
(Months of following year imports of goods and services)	2.0	1.9	1.9	1.9	2.0	2.1	2.2	2.6
Terms of trade index	7.2	-11.9	-5.0	5.9	0.5	2.2	2.6	1.3
GDP (millions of U.S. dollars)	42,631	45,999	49,707	55,150	60,984	67,287	74,408	81,763

Sources: Ethiopian authorities and IMF staff estimates and projections.

¹ Data pertain to Ethiopian fiscal year from July 8 to July 7.² For 2008/09 and 2009/10, other investment (net) includes a correction for the timing difference between entry of ETC imports and corresponding loan disbursements.

Table 6. Ethiopia: Alternative Scenario: Selected Economic and Financial Indicators, 2011/12–2018/19¹

	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19
	Act.	Prel.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
(Annual percentage change)								
National income and prices								
GDP at constant prices (at factor cost)	8.8	9.7	8.2	8.7	9.2	9.5	9.9	10.5
GDP deflator	34.3	4.6	7.3	7.5	6.1	6.3	6.4	6.2
Consumer prices (period average)	34.1	13.5	8.1	6.5	6.0	6.0	6.0	6.0
Consumer prices (end period)	20.7	7.4	8.5	6.0	6.0	6.0	6.0	6.0
External sector								
Exports (U.S. dollars, f.o.b.)	14.8	-2.6	9.1	16.5	17.8	18.5	18.6	18.6
Imports (U.S. dollars, c.i.f.)	33.5	4.1	12.7	17.5	10.1	7.0	6.5	6.4
Export volume	-0.2	9.4	14.7	11.0	18.8	17.4	16.5	17.6
Import volume	24.5	4.3	13.3	17.9	11.7	8.2	7.0	6.7
Terms of trade (deterioration –)	7.2	-11.9	-5.0	5.9	0.5	2.2	2.6	1.3
Nominal effective exchange rate (end of period)	2.8	-5.2	...	...	...	...	...	...
Real effective exchange rate (end of period)	19.7	-1.1	...	...	...	...	...	...
(Percent of beginning-period stock of broad money, unless otherwise indicated)								
Money and credit								
Net foreign assets	-11.6	3.1	-0.5	5.5	5.9	7.0	7.0	6.2
Net domestic assets (including other items net)	44.5	21.0	25.6	21.0	17.9	17.3	17.8	19.0
Broad money	32.9	24.1	25.1	26.4	23.8	24.3	24.9	25.2
Base money (annual percentage change)	0.4	13.6	16.7	17.6	16.4	16.8	17.3	17.6
Velocity (GDP/broad money)	3.91	3.64	3.39	3.16	2.97	2.79	2.62	2.46
(Percent of GDP, unless otherwise indicated)								
Financial balances								
Gross domestic savings	15.0	16.0	14.1	12.3	12.3	13.9	15.4	16.9
Public savings	5.7	5.8	3.3	3.1	3.3	3.8	4.6	5.5
Private savings	9.3	10.2	10.8	9.2	9.0	10.1	10.8	11.4
Gross domestic investment	33.1	33.0	31.5	30.7	29.8	29.7	29.2	28.7
Public investment	25.0	24.6	23.0	20.5	18.1	16.6	15.2	14.5
Private investment	8.0	8.4	8.5	10.2	11.7	13.1	14.0	14.2
Resource gap	-18.1	-17.0	-17.4	-18.4	-17.5	-15.8	-13.8	-11.8
External current account balance, including official transfers	-6.5	-6.0	-7.1	-7.4	-6.9	-5.8	-4.0	-2.2
Government finances								
Revenue	13.9	14.6	14.1	15.0	15.7	16.3	16.8	17.3
Tax revenue	11.6	12.5	13.0	13.9	14.6	15.1	15.6	16.1
Nontax revenue	2.3	2.0	1.1	1.2	1.2	1.2	1.2	1.2
External grants	1.7	1.5	1.6	1.5	1.3	1.2	1.1	1.1
Expenditure and net lending	16.8	18.1	18.4	19.1	19.5	19.7	19.9	20.4
Fiscal balance, excluding grants (cash basis)	-2.9	-3.5	-4.3	-4.1	-3.7	-3.5	-3.2	-3.1
Fiscal balance, including grants (cash basis)	-1.2	-2.0	-2.7	-2.6	-2.4	-2.3	-2.1	-2.0
Total financing (including residuals)	1.2	2.0	2.7	2.6	2.4	2.3	2.1	2.0
External financing	0.9	2.0	1.5	1.4	1.3	1.1	1.0	0.9
Domestic financing (not including privatization)	0.5	0.2	1.2	1.2	1.1	1.2	1.1	1.1
Public debt ²	32.7	37.4	44.7	49.8	53.1	55.0	54.7	53.5
Domestic debt	14.8	16.9	22.2	23.0	23.4	23.9	24.5	24.5
External debt (including to the IMF)	17.9	20.5	22.6	26.8	29.6	31.0	30.2	29.0
Overall balance of payments (in millions of U.S. dollars)	-1067	338	-57	669	870	1215	1426	1460
Gross official reserves (in millions of U.S. dollars)	2,262	2,368	2,761	3,430	4,300	5,515	6,942	8,402
(months of imports of goods and nonfactor services of following year)	2.0	1.9	1.9	2.1	2.5	3.0	3.5	4.0
GDP at current market prices (billions of birr)	739	853	995	1,170	1,361	1,590	1,864	2,192

Sources: Ethiopian authorities and IMF staff estimates and projections.

¹ Data pertain to Ethiopian fiscal year from July 8 to July 7.² Including debt of major public enterprises.

Table 7. Ethiopia: Millennium Development Goals

	1990	1995	2000	2005	2012
Goal 1: Eradicate extreme poverty and hunger					
Employment to population ratio, 15+, total (%) (modeled ILO estimate)	75	74	75	80	79
Employment to population ratio, ages 15-24, total (%) (modeled ILO estimate)	70	70	70	73	71
GDP per person employed (constant 1990 PPP \$)	1,289	1,177	1,284	1,427	2,173
Income share held by lowest 20%	..	7	9	9	8
Malnutrition prevalence, weight for age (% of children under 5)	43	..	42	35	29
Poverty gap at \$1.25 a day (PPP) (%)	..	21	16	10	8
Poverty headcount ratio at \$1.25 a day (PPP) (% of population)	..	61	56	39	31
Vulnerable employment, total (% of total employment)	..	91	91	91	..
Goal 2: Achieve universal primary education					
Literacy rate, youth female (% of females ages 15-24)	..	28	..	33	..
Literacy rate, youth male (% of males ages 15-24)	..	39	..	56	..
Persistence to last grade of primary, total (% of cohort)	29	20	61	61	37
Primary completion rate, total (% of relevant age group)	23	14	22	43	..
Adjusted net enrollment rate, primary (% of primary school age children)	29	22	40	61	..
Goal 3: Promote gender equality and empower women					
Proportion of seats held by women in national parliaments (%)	..	2	8	21	28
Ratio of female to male primary enrollment (%)	66	60	65	84	..
Ratio of female to male secondary enrollment (%)	77	80	67	60	..
Ratio of female to male tertiary enrollment (%)	22	26	28	32	..
Share of women employed in the nonagricultural sector (% of total nonagricultural employment)	..	..	40.9	43.8	41.6
Goal 4: Reduce child mortality					
Immunization, measles (% of children ages 12-23 months)	38	38	33	39	66
Mortality rate, infant (per 1,000 live births)	121	106	90	70	47
Mortality rate, under-5 (per 1,000 live births)	204	175	146	110	68
Goal 5: Improve maternal health					
Adolescent fertility rate (births per 1,000 women ages 15-19)	118	118	110	96	78
Births attended by skilled health staff (% of total)	..	..	6	6	10
Contraceptive prevalence (% of women ages 15-49)	5	3	8	15	29
Maternal mortality ratio (modeled estimate, per 100,000 live births)	1,400	1,200	990	740	420
Pregnant women receiving prenatal care (%)	..	..	27	28	43
Unmet need for contraception (% of married women ages 15-49)	..	..	35	34	26
Goal 6: Combat HIV/AIDS, malaria, and other diseases					
Children with fever receiving antimalarial drugs (% of children under age 5 with fever)	..	..	3	3	26
Condom use, population ages 15-24, female (% of females ages 15-24)	..	..	2	2	3
Condom use, population ages 15-24, male (% of males ages 15-24)	..	..	20	18	25
Incidence of tuberculosis (per 100,000 people)	367	419	421	342	247
Prevalence of HIV, female (% ages 15-24)	..	..	..	..	0.5
Prevalence of HIV, male (% ages 15-24)	..	..	..	..	0.3
Prevalence of HIV, total (% of population ages 15-49)	1.3	3.1	3.7	2.6	1.3
Tuberculosis case detection rate (% of all forms)	50	11	33	48	64
Goal 7: Ensure environmental sustainability					
CO2 emissions (kg per PPP \$ of GDP)	0	0	0	0	0
CO2 emissions (metric tons per capita)	0	0	0	0	0
Forest area (% of land area)	15.2	14.4	13.7	13	12.2
Improved sanitation facilities (% of population with access)	2	3	8	15	24
Improved water source (% of population with access)	13	20	29	38	52
Marine protected areas (% of territorial waters)	..	..	..	..	1
Goal 8: Develop a global partnership for development					
Net ODA received per capita (current US\$)	21	15	10	25	36
Debt service (PPG and IMF only, % of exports of goods, services and primary income)	38	18	15	2	7
Internet users (per 100 people)	0	0	0	0.2	1.5
Mobile cellular subscriptions (per 100 people)	0	0	0	1	22
Telephone lines (per 100 people)	0	0	0	1	1
Other					
Fertility rate, total (births per woman)	7.2	7	6.5	5.7	4.6
GNI per capita, Atlas method (current US\$)	250	140	120	160	410
GNI, Atlas method (current US\$) (billions)	12.1	8.2	8.1	12.1	37.5
Gross capital formation (% of GDP)	14.6	20.2	23.1	26.5	33.1
Life expectancy at birth, total (years)	47	49	52	57	63
Literacy rate, adult total (% of people ages 15 and above)	..	27	..	30	..
Population (Total) (billions)	0	0.1	0.1	0.1	0.1
Trade (% of GDP)	14.6	25.7	36.4	51.1	45.9

Source: World Development Indicators.

Table 8. Ethiopia: Financial Soundness Indicators of the Commercial Banking Sector, 2009–14

(in percent, unless otherwise indicated)

	Jun-09	Jun-10	Jun-11	Jun-12	Jun-13	Mar-14 ¹
Capital adequacy						
Capital to Risk-Weighted Assets	18.7	18.7	18.1	13.4	17.9	17.2
Regulatory Capital Tier I to Risk-Weighted Assets	18.7	18.7	18.1	13.4	17.9	17.2
Capital to Assets	9.6	9.1	7.8	6.7	7.2	6.8
Asset quality						
NPLs to Total Loans	6.0	3.5	2.1	1.4	2.5	2.9
NPLs Net of Provisions to Capital	7.3	0.7	-3.8	-5.6	-0.5	4.3
Earning and profitability						
ROA	3.3	3.1	3.0	4.1	3.2	3.1
ROE	33.8	34.4	34.9	55.8	48.0	44.6
Gross Interest Income to Total Income ²	57.1	60.1	54.4	54.7	64.9	64.5
Interest Margin to Gross Income	50.6	38.7	40.0	45.0	56.2	55.0
Non-interest Expenses to Gross Income ³	27.8	28.0	28.7	26.6	33.6	35.3
Personnel Expenses to Non-interest Expenses	50.5	46.0	51.1	42.3	43.3	53.3
Liquidity						
Liquid Assets to Total Assets	30.8	32.7	32.7	20.6	23.2	15.4
Liquid Assets to Short-term liabilities	40.4	42.7	43.4	26.7	30.1	19.9

Source: Ethiopian authorities.

¹ Earning ratios indicated for March 2014 is provisional.

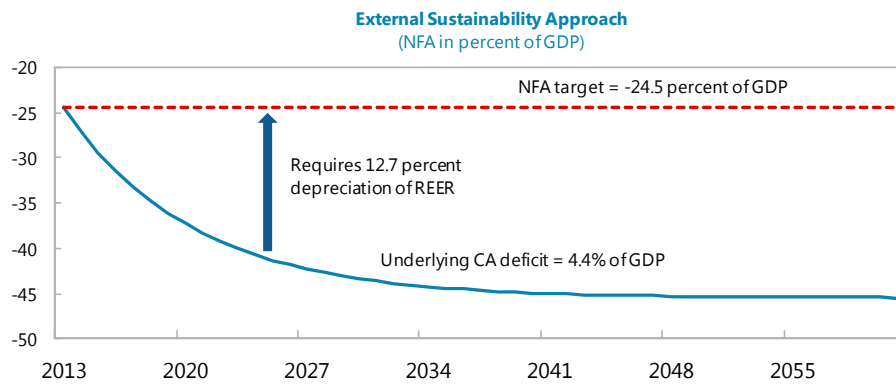
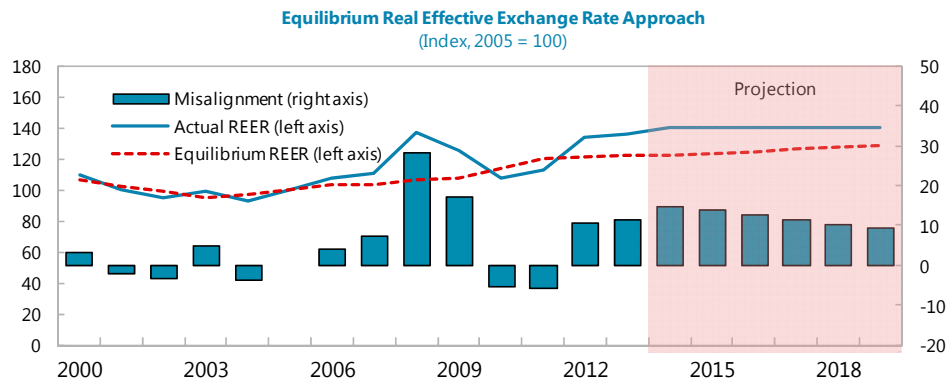
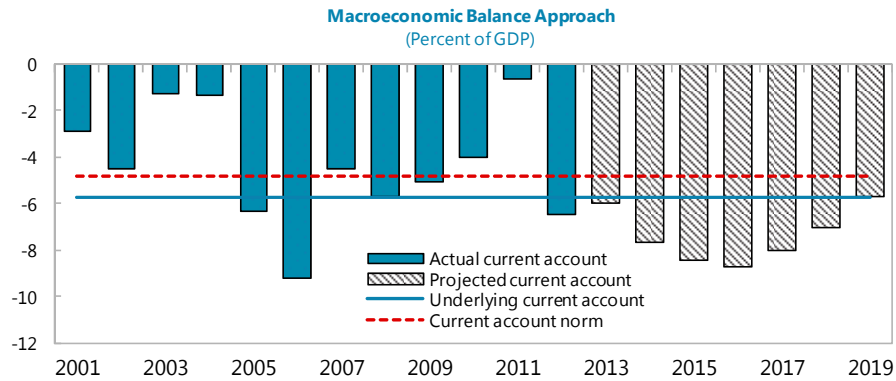
² Total income comprises gross interest income and gross non-interest income.

³ Gross income comprises net interest income and total non-interest income.

Annex I. Exchange Rate Assessment

- 1. The assessment of the exchange rate for the fiscal year 2013/14 is based on the IMF's Consultative Group on Exchange Rate (CGER) methodology which indicates an overvaluation of the real effective exchange rate in the range of 10 to 13 percent.** The misalignment has been reduced slightly since the 2013 Article IV consultation. The standard CGER methods applied are (i) the macroeconomic balance approach, (ii) the equilibrium real effective exchange rate (REER) approach, and (iii) the external sustainability approach.
- 2. The macroeconomic balance approach estimates an overvaluation of 9.7 percent.** According to this methodology, a REER depreciation of that magnitude would align the current account with its equilibrium level. The current account deficit is expected to be large but declining over the medium term--estimated at 7.1 percent of GDP in 2013/14 and shrinking to 5.0 percent of GDP over the next five years. The norm current account balance is also negative (5.8 percent of GDP), partly supported by the large inflow of remittances and international development aid that is expected to continue in the medium term. As in the previous Article IV consultation, large level of imports is forecasted over the medium term, mostly petroleum products and heavy construction equipment. A depreciation of around 10 percent in the REER would be necessary to close the current account gap.
- 3. The equilibrium real effective exchange rate approach shows an overvaluation around 9 percent.** This result reflects unfavorable and highly volatile terms of trade and is predicated on a sustained level of remittances from the diaspora, and government expenditure partially financed by large external transfers.
- 4. The external sustainability approach suggests an overvaluation of the REER of 12.7 percent.** This methodology calculates the current account balance that stabilizes the net foreign asset (NFA) position at a sustainable level. Nominal GDP growth is estimated at 17.9 percent on average from FY2013/14 to FY2018/19, and the underlying current account deficit of 4.4 would result in a long-run NFA position of -45 percent of GDP. To sustain the NFA position at -24.5 percent (average of last five years), the current account deficit should be 3 percent of GDP which would require a depreciation of 12.7 percent in the REER.

Figure I.1. Ethiopia: Exchange Rate Assessment



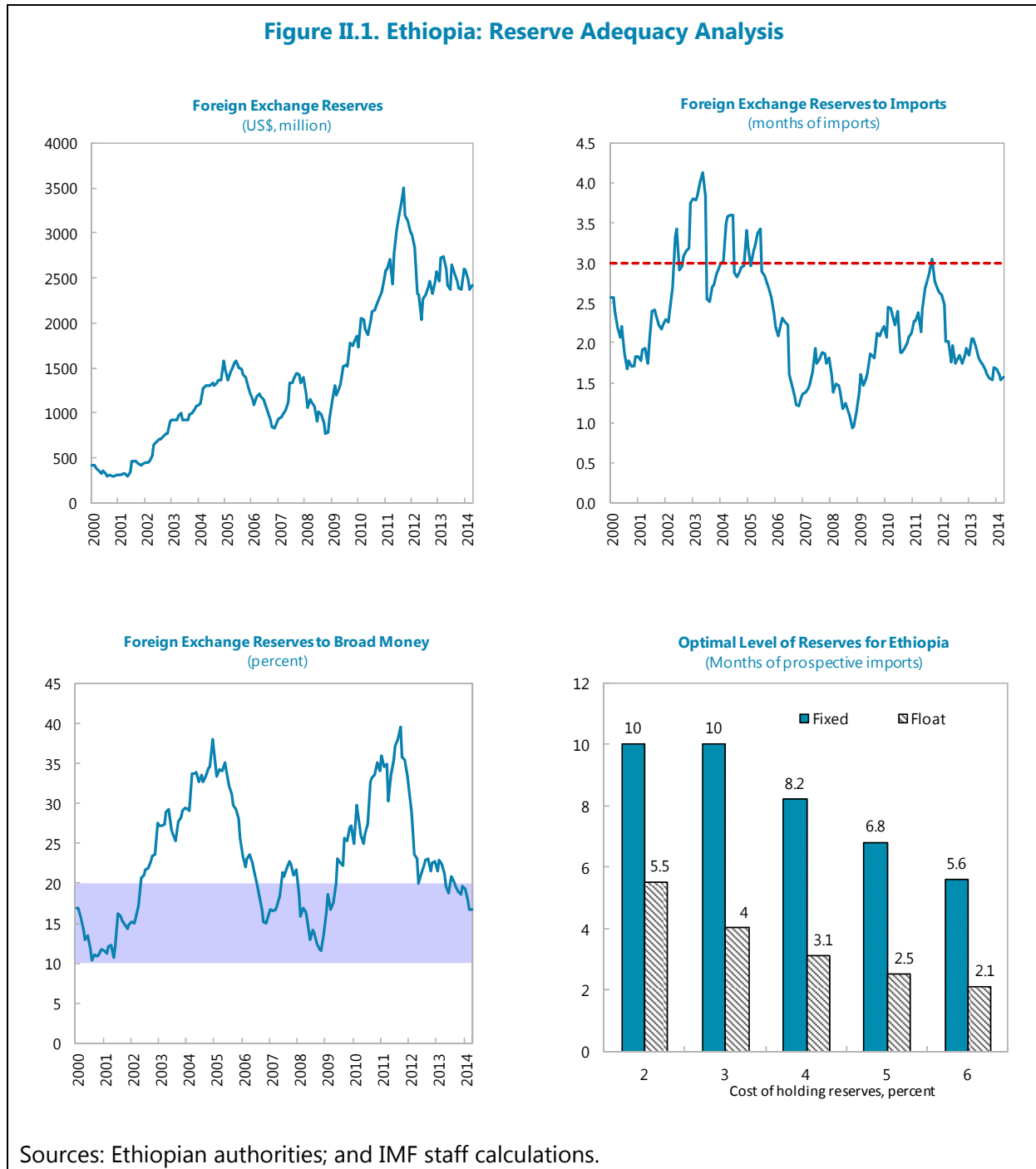
Sources: Ethiopian authorities; and IMF calculations.

Annex II. Reserve Adequacy Assessment

1. **Despite high and sustained economic growth achieved in recent years, the income level is still low and the economy is dependent on agricultural commodity exports and imported fuel and capital goods.** The economy remains vulnerable to potential terms-of-trade shocks and has a limited capacity to absorb them, given the chronically low reserve coverage. Some export diversification and the expansion in the international transportation sector offer some potential for higher accumulation of international reserves in the coming years.
2. **In addition, Ethiopia receives a large volume of private transfers from Ethiopians living abroad.** Remittances averaged about US\$3.7 billion in the last three fiscal years, higher than the value of total exports of goods during the same period. The large trade deficit is also partially offset with official transfers that reached US\$1.3 billion in 2013/14.
3. **Accumulation of reserves has proved to be difficult.** Despite the recent recovery in reserves that reached US\$2.7 billion at end-February 2013, reserves have fluctuated around US\$2.8 billion for most of FY2013/14 and were at that level by end-April 2014.
4. **The reserve coverage in months of imports has reached uncomfortably low levels.** At end-April 2014 reserves covered only about 1.9 months of prospective imports. Given the relatively high level of imports expected in the coming years, further accumulation of reserves is needed to improve the coverage and have a buffer against possible deterioration of the terms of trade. The export diversification strategy would also be important in addressing the recent decline in reserves.
5. **Reserves in percent of broad money have fallen just below the 20 percent threshold.** Although there are no large portfolio capital flows to and from Ethiopia, in the context of a managed exchange rate, the reserves level seems inadequate. The recent declining trend in the reserve to broad money ratio raises concern, although prudent monetary policy has helped to contain the decline in the ratio. The declining trend has been persistent in the last two years.
6. **Reserve adequacy assessment based on a cost-benefit analysis shows that for a country with a fixed exchange rate regime with assumed cost of holding foreign reserves is at 5 percent, the optimal reserve coverage would be the equivalent of 6.8 months of imports.¹** The model evaluates various shocks in external demand, terms of trade, FDI, and aid flows for

¹ Based on Dabla-Norris, Kim, and Shirono, 2011, "Optimal Precautionary Reserves for Low-Income Countries: A Cost-Benefit Analysis," IMF Working Paper 11/249.

different cost levels of holding reserves. Remittances are not explicitly included in the calculation of the cost-benefit analysis. Given the substantial and sustained inflow of foreign exchange to Ethiopian households in the form of remittances would suggest lower optimal reserve coverage for a given cost of holding those reserves.





THE FEDERAL DEMOCRATIC REPUBLIC OF ETHIOPIA

STAFF REPORT FOR THE 2014 ARTICLE IV CONSULTATION—DEBT SUSTAINABILITY ANALYSIS

September 5, 2014

Approved By

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Prepared by the International Monetary Fund and the International Development Association.

Based on the new Low-Income Country Debt Sustainability Analysis (LIC DSA) framework, the updated DSA found that Ethiopia's risk of external debt distress remains low, but exposure to adverse shocks to exports shifts the risk to the borderline. The DSA indicates that Ethiopia's overall public sector debt dynamics is sustainable under the baseline scenario, but vulnerable under several alternative scenarios. Public sector debt ratios are projected to decline in the medium and long-term. The baseline scenario with a medium and long-term favorable trend in the main indicators, places the debt-to-exports ratio close to the threshold for a short period, with shocks to exports and borrowing conditions temporarily breaching the PV of debt-to-exports threshold. This underscores the need for the government to develop a strategy to contain the primary deficit as assumed in the baseline. A rapid increase in domestic public debt and non-concessional external borrowing could affect the risk assessment of Ethiopia. Maintaining the growth of exports through diversification of the export sector, developing a medium-term debt strategy for the public sector, and prudent non-concessional borrowing from external sources, remain crucial to maintaining a low risk of external debt distress.

BACKGROUND AND KEY FINDINGS

1. The last Debt Sustainability Analysis (DSA), prepared in August 2013, concluded that Ethiopia was at a low risk of external debt distress. Past reports explained that Ethiopia reached the completion point under the Heavily Indebted Poor Countries (HIPC) Initiative in 2004 and benefited from debt relief under the Multilateral Debt Relief Initiative (MDRI) in 2006.¹ In 2011/12,² public and publicly guaranteed (PPG) external debt declined to 18.4 percent of GDP, more than 5 percentage points relative to the previous year.³ High GDP growth and negative domestic real interest rates on public debt contributed to the decline.

2. Previous DSA findings have been robust to the inclusion of remittances and higher non-concessional loans. Last year's external DSA did not result in any breach of indicative thresholds with or without remittances and debt-to-exports ratios were better in the baseline with those private transfers. The assessment was thus made not taking into account remittances, as recommended in the LIC DSA framework, and there was evidence of low risk of external debt distress. An alternative scenario and a general equilibrium model stretching the non-concessional borrowing for public investment on infrastructure confirmed the capacity of the country to absorb those resources.⁴ Nonetheless, as Ethiopia reaches new debt levels, the assessment of the external DSA calls for the use of additional tools (as provided under the new Debt Sustainability Framework).

3. Ethiopia remains at low risk of external debt distress in 2014, but debt levels now warrant extended analysis of the incremental risk of higher debt and vulnerability of exports to terms of trade shocks and terms of loan. The present value (PV) of PPG external debt is expected to continue to increase from 14.1 percent of GDP in 2012/13 to 15.4 percent of GDP in 2013/14 under baseline scenario. The ratio of PV of PPG external debt to exports would rise from 110.6 percent to 115.0 percent in the same period, as a result of the additional buildup of external debt and low level of exports. The inclusion of remittances significantly lowers the baseline average of the debt-to-exports ratios in the projection period (2013/14–2033/34), but the results excluding and including workers' remittances are broadly the same.⁵

¹ While Ethiopia has received debt relief from most of its creditors, it has not been able to reach agreement with bilateral official creditors from Bulgaria, Libya, and FR Yugoslavia and commercial creditors from Italy, former Czechoslovakia, India and FR Yugoslavia whose outstanding loans (US\$382.9 million) accounted for 4.5 percent of the debt stock in 2012/13. HIPC terms are assumed for these loans. Negotiations with Russia on outstanding loans (US\$161.6 million) have not completed. Thus, the debt service on these loans is assumed HIPC comparable treatment.

² The Ethiopian fiscal year runs from July 8 to July 7.

³ PPG debt includes not only federal and regional governments' debt, but also encompasses all major state-owned enterprises, except Ethiopian Airlines (EAL). EAL debt is excluded from PPG debt, because, although owned by the government, it is run on commercial terms. EAL enjoys managerial independence, borrows without any government guarantees, publishes annual audited reports and has a sizeable profit margin.

⁴ See Buffie et al (2014), 'Borrowing for Growth: Big pushes and Debt Sustainability in Low-income Countries', April (2014) and Box 1 in the main report.

⁵ Based on the 2013 Country Policy and Institutional Assessment (CPIA) score (3.4), Ethiopia is classified as a medium performer. The thresholds for the debt burden for medium performers are 150, 40, and 250 for the PV of debt to

(continued)

There is a short-lived breach of the PV of debt-to-exports ratio under the exports and borrowing conditions shocks, that makes Ethiopia a borderline case under the new DSF and requires the use of additional country specific information to perform the DSA.

Table 1. Ethiopia: Comparison of PPG External Debt Baseline Scenario

Fiscal year ending July 7	2014	2015	2016	2017	2018	2019	2024	2034
(Percent, unless otherwise indicated)								
PV of Debt to Exports Ratio								
2014DSA	115.0	135.9	141.9	141.1	131.9	120.1	78.7	25.2
2013DSA	116.8	120.9	124.1	122.2	117.6	113.4	92.6	...
PV of Debt to GDP Ratio								
2014DSA	15.4	18.9	21.0	21.9	21.3	20.4	15.3	6.7
2013DSA	16.4	17.5	18.8	19.1	19.0	18.9	16.2	...
PV of Debt to Revenue Ratio								
2014DSA	102.0	131.5	147.1	154.6	149.4	140.8	105.4	38.7
2013DSA	127.9	131.9	141.9	144.6	144.7	140.8	121.9	...
Debt Service to Exports Ratio								
2014DSA	7.7	9.0	8.8	8.7	8.4	8.6	7.7	2.7
2013DSA	6.4	7.2	7.1	7.5	8.1	8.4	8.2	...
<i>Memorandum items:</i>								
Grant Element of New External Borrowing								
2014DSA	25.7	21.8	22.9	25.6	33.0	34.1	35.3	34.9
2013DSA	24.4	25.0	23.6	28.0	27.8	26.8	29.0	...
New Commercial Loan Disbursements (billions of U.S. dollars)								
2014DSA	0.948	2.707	2.271	1.745	0.930	0.820	0.815	0.750
2013DSA	1.037	1.010	1.111	0.752	0.744	0.789	0.695	...
Real GDP Growth (annual percent change)								
2014DSA	8.2	8.5	8.5	8.0	8.0	7.5	6.5	6.5
2013DSA	7.5	7.5	7.0	7.0	7.0	6.5	6.5	...
Current Account Balance to GDP Ratio								
2014DSA	-7.1	-7.3	-6.7	-5.8	-5.5	-6.2	-4.0	-2.7
2013DSA	-5.7	-6.0	-5.8	-5.6	-5.2	-5.0	-4.4	...

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

exports, GDP, and revenue, respectively; a 10 percent band is applied to the thresholds to determine if the country is a borderline case; debt service thresholds are 20 and 30 percent of exports and revenue, respectively. In the scenarios that include workers' remittances, the corresponding threshold for PV of debt to exports and remittances is 120 percent, and is 16 percent for debt service to exports and remittances; the PV of debt to GDP and remittances is 36 percent.

4. The current DSA assumes a decline in the share of concessional loans and higher nonconcessional external loan disbursements between 2014/15 and 2019/20. Compared to the previous DSA, a greater increase in projected commercial loan disbursements for financing large investments by state-owned enterprises in the next five years is the main contributor to the buildup of new debt in the medium term. New commercial loans will result in subsequent increases in the various debt ratios and an increase in the grant element on new borrowing throughout the projection period. This DSA assumes disbursements of about US\$1.7 billion in nonconcessional loans a year in the next five years, with Ethiotel (the telecommunications company) taking US\$1.6 billion over three years. The DSA assumes that nonconcessional loan disbursements will remain at around US\$745 million on average over the projection period (FY2018/19–FY2033/34). Over the time horizon of the DSA, 58 percent of new external loans are assumed to be concessional on average. Average maturity on all new external loans is assumed to be 26 years while new non-concessional loans are assumed to carry a maturity of 13–16 years. Average interest rates on new external loans are assumed at 2.2 percent over the horizon, and interest rates on new non-concessional loans are assumed to be in the 3–5 percent range.

5. In April 2013, IDA authorized a US\$1 billion ceiling for FY12/13 and, in principle, FY13/14 and FY14/15 for Ethiopia. In June 2014, IDA concluded that Ethiopia had exceeded this limit by committing non concessional contracts totaling US\$5.8 billion in FY12/13 and an estimated US\$2.7 billion in FY13/14. In response, IDA converted the grant portion of the FY14/15 volume into regular credits and reduced Ethiopia's allocation for FY14/15 by 5 percent. Financing needs covered with non-concessional borrowing have been revised upwards from the previous DSA in view of the large cost of big projects in telecommunications, railways, roads, airport and sugar. Those projects have been identified as crucial for the success of the authorities' Growth and Transformation Plan (GTP). Frontloaded disbursements are associated with realistic pace of execution and the immediate needs for investment and related acquisitions in those sectors.

6. Commercial loans to finance large public investment projects by state-owned enterprises could increase the risk to Ethiopia's public debt sustainability. The state-owned power company, the Ethiopia Electricity Power Company, now divided into two entities for generation and distribution, is undertaking several large investment projects. Most rely on external assistance and loans (including both concessional and non-concessional), while the Renaissance Dam project, estimated by the authorities to cost 8.5 percent of 2013/14 GDP, is intended to be financed entirely domestically (except for the external non-concessional financing of the transmission line). The Ethiopian Railway Corporation signed contracts with Chinese and Turkish companies for projects whose total size is more than US\$3.9 billion, or 7.8 percent of 2013/14 GDP. The telecommunication company signed two agreements with Chinese providers for US\$1.6 billion suppliers' loans. As advised in previous DSAs, it would be prudent for the authorities to systematically update a medium-term debt management strategy (that includes SOEs) and to start monitoring the overall debt (external and domestic) of the consolidated public sector.

7. Authorities requested again the exclusion of the commercial external loans in the telecommunication sector from the DSA. While they agreed with the findings of the DSA, they specifically requested the exclusion of the commercial loans that Ethiotel has signed with Chinese equipment suppliers for a total of US\$1.6 billion. The conditions of those loans are non-concessional and

the authorities explained that there is no government guarantee. The delivery of some of the equipment has been delayed and the authorities argued that capacity to absorb the resources and to put in place the equipment has been slow in the past. Contrary to the assumed parsimony in the previous DSA, staff found evidence for a frontloading of the disbursements, given the high relevance of the associated projects to achieve the goals under the GTP, and the fact that some projects have already been started. The authorities have also indicated that they intend to establish an agency to monitor and oversee the financial positions of all public enterprises and their overall impact on public sector finances.

MACROECONOMIC ASSUMPTIONS

8. The medium-term macroeconomic outlook incorporates an upward revision to output growth compared to the assumptions of the 2013 DSA (Box 1). Real GDP growth is forecasted at 8.2 percent in 2013/14 and 8.5 percent in the following two years, reflecting strong economic activity, mainly led by public infrastructure investment and favorable agricultural production. The projected long-run GDP growth rate is maintained at 6.5 percent.

9. Export growth is projected to recover from its weak performance in FY2012/13, while imports continue at a fast pace led by capital goods, fuel and other inputs. In the medium- to long-run, export growth would be supported by diversification of the export sector as Ethiopia explores new markets, consolidates the existing ones, and develops new export industries and markets new products, spurred by greater inflows of foreign direct investment, and domestic investments to boost service exports including electricity and international travel. Overall, exports of goods and services are projected to grow at 15 percent each year from 2014/15 to 2019/20.

EXTERNAL DEBT SUSTAINABILITY ANALYSIS

10. Under the baseline scenario (not including remittances), the PPG external debt indicators will rise in the next several years, but will remain under the relevant indicative thresholds (Figure 1). The PV of PPG external debt in percent of GDP would slightly increase in 2013/14 to 15.4 percent and is projected to reach 22.0 percent by 2016/17, reflecting the assumed steady increase in new loan disbursements, and subsequently would decline below 10 percent in the long run. The PV of debt in percent of exports reached 115.0 percent in 2013/14; and despite the expected recovery in exports, it is projected to continue increasing, peaking at 141.9 percent in 2015/16. The debt service-to-exports ratio remains well below the relevant threshold although it keeps rising to a peak of 9.0 percent in 2014/15, reflecting servicing of non-concessional loans by public enterprises.

11. Under the historical scenario, the debt stock indicators would be lower than under the baseline scenario. The scenario reflects significantly higher nominal GDP and export growth (than in the baseline), which helps to lower the debt ratios. It also reflects larger net debt creating flows (than in the baseline) that increases the debt ratios. The dynamic path under the historical scenario is determined by these two offsetting forces.

Box 1. Ethiopia: Macroeconomic Assumptions for the Baseline Scenario

Based on a partial financing of the Growth and Transformation Plan (GTP), real GDP growth is projected at 8.2 percent in 2013/14, 8.5 percent in the following two years, and to slightly tump down to 8.0 percent until 2018/19 and to remain at 6.5 percent in the outer years.¹ This assessment contrasts with the government's growth projections in the GTP, and reflects remaining rigidities and constrains, given the limited space for private sector credit. CPI Inflation is projected to reach 8.5 percent by the end of 2013/14 and to stay at 9 percent in the long run. The primary balance of the public sector is projected to remain around -2.2 percent of GDP in average for the next five years, reflecting a substantial effort on tax collection and current expenditure.

The external current account deficit (before official transfers) is estimated at 9.8 percent in 2013/14. A further deterioration to 10.9 percent for next year will follow a slight improvement over the long-run to 6.8 percent in 2033/34.

Exports of goods and services are projected to grow by 12.5 percent in 2013/14, after a decline of 0.7 percent in 2012/13, and with an average growth of about 13.2 percent in the long run. A prolonged decline in commodity prices, especially in gold and coffee, largely offset gains in export volumes and other agricultural exports. Investments in targeted sectors that receive government support are expected to contribute to export growth, with export volume growth of about 14.7 percent for 2013/14 and about 13 percent in the next four years to just below 8 percent over the remaining DSA horizon. Imports of goods and services are projected to increase slightly above GDP as demand for imported capital goods is expected to grow fast during the GTP implementation. In the long run, imports are expected to grow in line with domestic output.

Workers' remittances have played a key role in supporting the balance of payments and in 2013/14 are expected to reach 8 percent of GDP. High growth, economic stability and the return of growth in developed countries is expected to maintain remittances at around 7 percent of GDP in the next five years and 4 percent in the long run.

Foreign direct investment (FDI) is projected increase from 2.7 percent of GDP in 2013/14 to 3.3 percent the following year and 3 to 5 percent in average in the medium and long term, on account of policies to promote greater foreign investment.

¹ Domestic financing and prospective external inflows amount roughly to two third of full financing of the GTP.

12. The terms-of-trade shock is the most extreme potential risk for the sustainability of the external debt, breaching the threshold of PV of debt-to-exports ratio from 2015/16 to 2017/18 (without remittances). This makes the DSA for Ethiopia a borderline case. A potential deterioration in the terms-of-trade and a drastic change in the borrowing conditions could force a temporary breach of the PV of debt-to-exports ratio. The short-lived breach of just one indicator and the declining long-term trends indicate that Ethiopia is a special case that conforms to the borderline situation described in the most recent revision of the DSF. With other indicators well below the thresholds even for the most extreme shocks, the new DSA template provides for a further evaluation based in the probabilistic approach that takes into consideration historical growth performance. This complementary approach assesses the evolution of the probability of debt distress over time. In the case of Ethiopia, with high and sustained

economic growth, the additional evaluation indicates that the country's probability of debt distress is low even for the most extreme shocks (Figure 2).

PUBLIC DEBT SUSTAINABILITY ANALYSIS

13. Under the baseline scenario and similar to the findings in the 2013 DSA, the total public sector debt-to-GDP ratio would rise in the near term, but would start to decline in the medium- to long-term. This reflects large domestic borrowing and continued accumulation of external PPG debt by public enterprises to implement infrastructure investment projects contemplated in the GTP. It is expected that after an initial period of high spending, total public sector expenditure would revert to a lower level in the long run. Under the new DSF that imposes a threshold for the PV of Debt-to-GDP ratio, only the scenario that fixes the primary balance at a level in recent fiscal performance shows the ratio crossing the threshold with a growing trend. This is explained largely by the fact that Ethiopia has reported a higher primary deficit than in previous year, associated with the recent large investments that are part of the GTP. This is unlikely to remain unchanged in the next 20 years.

14. Debt stock related indicators are relatively flat and most extreme shocks do not alter significantly the results. All debt indicators show a mild increase in the medium-term, to return to levels similar to the 2013/14 ones. This result is predicated on the continuation of robust GDP growth, moderate public sector primary deficits, and most crucially - the authorities' policy of keeping domestic interest rates low. Real interest rates are assumed to remain in mildly negative territory with inflation expected to stay at 9 percent in the long run.

15. Public sector debt would grow in the long-run as a result of a permanent negative shock on GDP growth, but debt service-to-revenue could absorb this shock (Figure 3). The scenario with unchanged primary balance from 2013/14 shows particularly sharp deterioration because of the unusually large primary deficit in that particular year reflecting the high level of investment activity. The other two alternative scenarios (real GDP growth and primary balance at the historic average) permanently lower GDP growth and show trajectories with no important changes in the debt ratios during the DSA horizon.

16. The baseline scenario understates the public debt burden for the economy, because it reflects actual costs of borrowing by the public sectors, which remain significantly lower than inflation. Like in the previous DSA, with inflation projected to remain at a single-digit level, under current policy, interest rates on public enterprise domestic borrowing would not be at positive levels in real terms. Ethiopia's relatively benign public sector debt outlook hinges strongly on the continuation of the current interest rate policy. If the actual cost of borrowing were to rise above inflation, the debt indicators would worsen or fiscal adjustment would be required to maintain sustainability.

17. This assessment with a low risk of debt distress assumes disbursements of external borrowing lower than required for the GTP. The ongoing large public investment projects rely heavily on domestic financing and would lead to a large accumulation of public debt. Without an appropriate pacing of the public investment projects in the GTP, financing for the private sector could be squeezed. Monitoring the operations of the consolidated public sector, including contingent liabilities arising from financial transactions among public entities, is thus important.

CONCLUSION

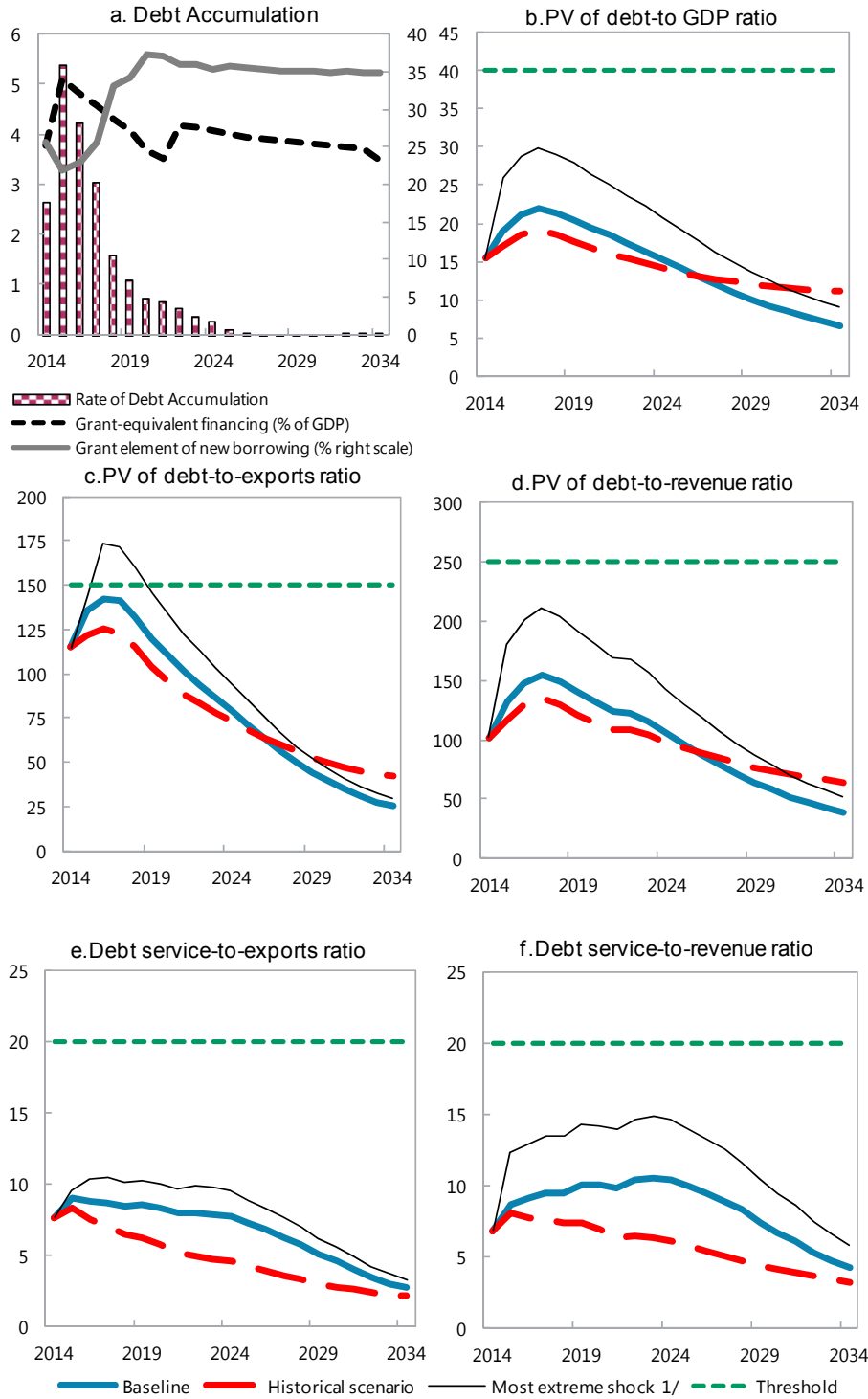
18. The risk rating of Ethiopia's external and public debt distress remains low, but is on the cusp.

Potential changes in the risk assessment can be triggered by a terms-of-trade shock or incurring higher than forecasted external debt as well as contracting debt on less favorable terms. The external debt ratios have been on a growing trend in recent years, and this trend is projected to continue over the medium-term. The results point to Ethiopia as a borderline case, with debt indicators and sensitivity analysis suggesting that the risk of debt distress may change from low to moderate. The exposure to a terms-of-trade shock is reflected in a short lived breach in the PV of debt-to-exports ratio under the most extreme shock. A milder terms-of-loans shock also breached this threshold for a short period.

19. The Ethiopian authorities need to monitor closely the debt levels and the terms of the new loans, especially on commercial terms.

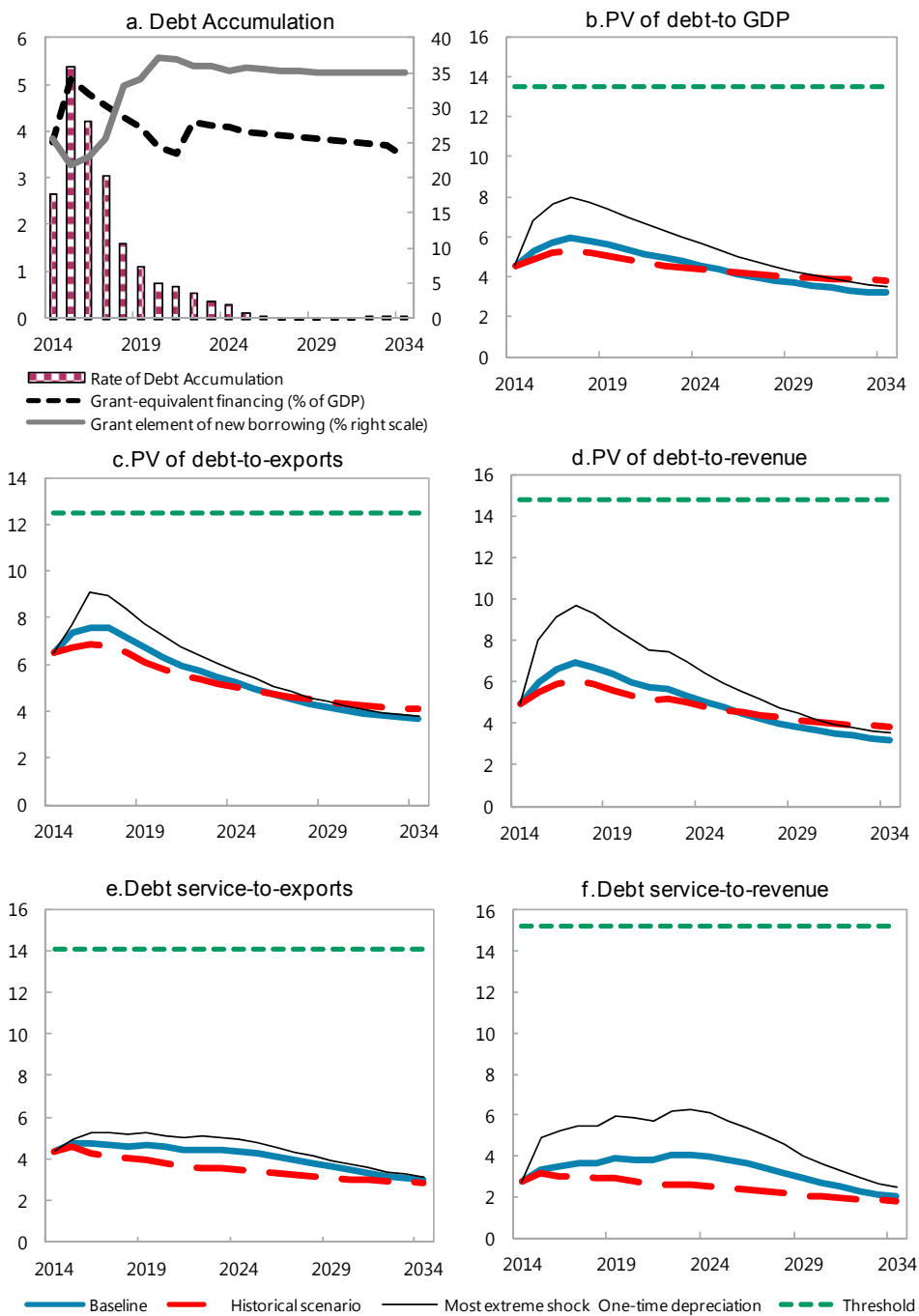
The additional external debt intended to finance large projects on state own enterprises should be supported by higher exports. In this sense, ensuring the successful transition to a more competitive and diverse economy with a clear outward orientation is key to preserving the low risk of debt distress. The financing plan underlying the remaining GTP I and what is envisioned in the next GTP, should take into account these results. In addition to export diversification and improvements to competitiveness, particular emphasis should be placed on adequate concessionality of new external loans.

Figure 1. Ethiopia: Indicators of Public Guaranteed External Debt Under Alternative Scenarios, 2014–34¹



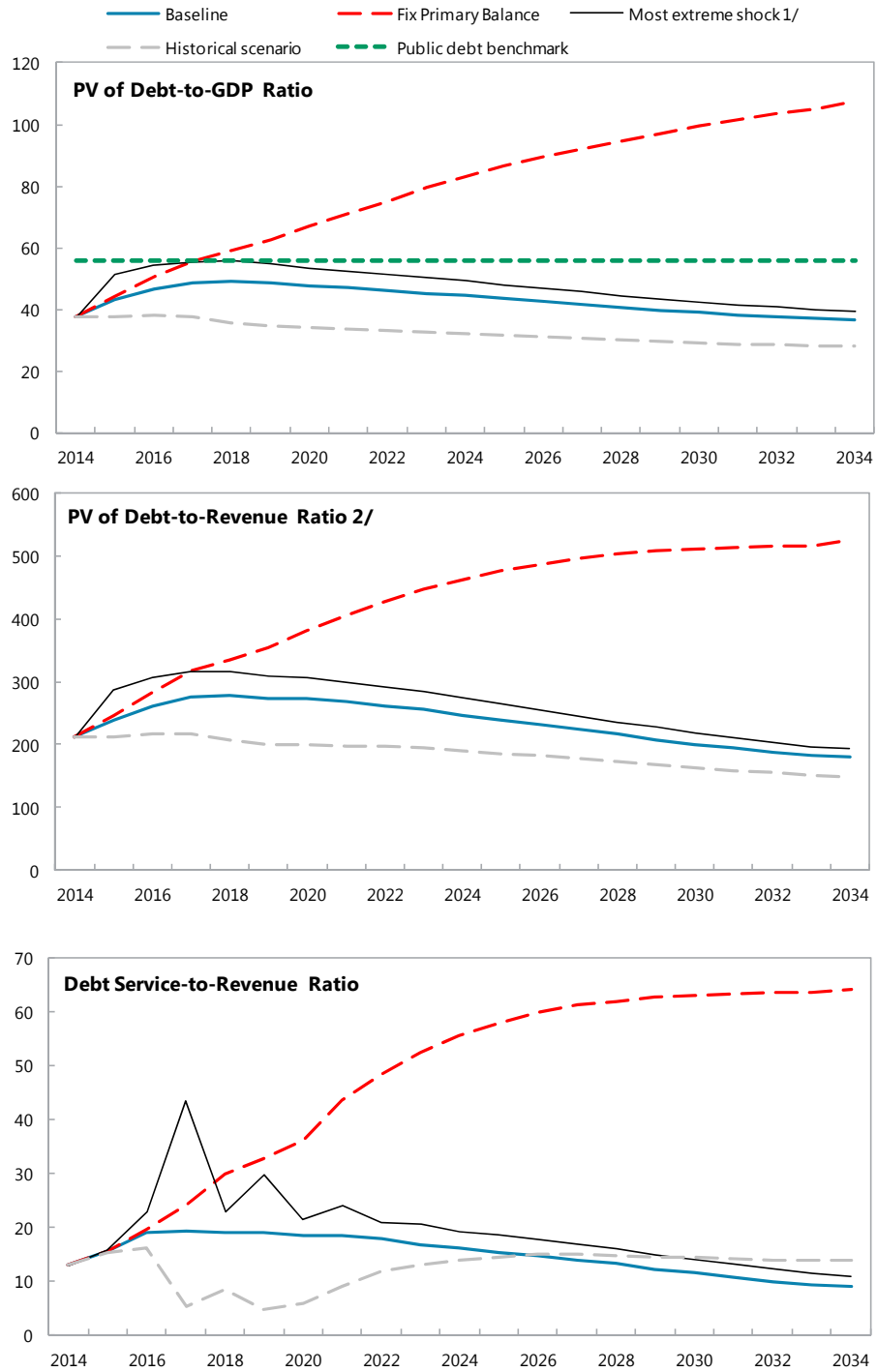
Sources: Ethiopian authorities; and IMF and World Bank staff estimates and projections.
 1/ The most extreme stress test is the test that yields the highest ratio on or before 2024. In figure b. it corresponds to a One-time depreciation shock; in c. to a Exports shock; in d. to a One-time depreciation shock; in e. to a Exports shock and in figure f. to a One-time depreciation shock.

Figure 2. Ethiopia: Probability of Debt Distress of Public and Publicly Guaranteed External Debt under Alternative Scenarios, 2014–34¹



Sources: Ethiopian authorities; and IMF and World Bank staff estimates and projections.
 1/ The most extreme stress test is the test that yields the highest ratio on or before 2024. In figure b. it corresponds to a One-time depreciation shock; in c. to a Exports shock; in d. to a One-time depreciation shock; in e. to a Exports shock and in figure f. to a One-time depreciation shock.

Figure 3. Ethiopia: Indicators of Public Debt under Alternative Scenarios, 2014–34¹



Sources: Ethiopian authorities; and IMF and World Bank staff estimates and projections.
 1/ The most extreme stress test is the test that yields the highest ratio on or before 2024.
 2/ Revenues are defined inclusive of grants.

Table 3. Ethiopia: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2014–34

	Projections							2034
	2014	2015	2016	2017	2018	2019	2024	
PV of debt-to GDP ratio								
Baseline	15	19	21	22	21	20	15	7
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2014-2034 1/	15	17	19	19	19	18	14	11
A2. New public sector loans on less favorable terms in 2014-2034 2	15	19	23	25	25	25	21	13
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2015-2016	15	18	20	21	20	19	14	6
B2. Export value growth at historical average minus one standard deviation in 2015-2016 3/	15	19	22	23	22	21	16	7
B3. US dollar GDP deflator at historical average minus one standard deviation in 2015-2016	15	20	24	24	24	23	17	7
B4. Net non-debt creating flows at historical average minus one standard deviation in 2015-2016 4/	15	19	22	22	22	21	15	7
B5. Combination of B1-B4 using one-half standard deviation shocks	15	18	20	21	20	20	15	6
B6. One-time 30 percent nominal depreciation relative to the baseline in 2015 5/	15	26	29	30	29	28	21	9
PV of debt-to-exports ratio								
Baseline	115	136	142	141	132	120	79	25
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2014-2034 1/	115	121	125	123	115	104	73	42
A2. New public sector loans on less favorable terms in 2014-2034 2	115	139	154	159	154	144	109	50
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2015-2016	115	131	137	136	127	116	76	24
B2. Export value growth at historical average minus one standard deviation in 2015-2016 3/	115	144	174	172	160	145	94	29
B3. US dollar GDP deflator at historical average minus one standard deviation in 2015-2016	115	131	137	136	127	116	76	24
B4. Net non-debt creating flows at historical average minus one standard deviation in 2015-2016 4/	115	134	146	145	135	123	79	25
B5. Combination of B1-B4 using one-half standard deviation shocks	115	131	147	146	136	124	81	26
B6. One-time 30 percent nominal depreciation relative to the baseline in 2015 5/	115	131	137	136	127	116	76	24
PV of debt-to-revenue ratio								
Baseline	102	132	147	155	149	141	105	39
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2014-2034 1/	102	117	130	135	130	122	98	64
A2. New public sector loans on less favorable terms in 2014-2034 2	102	135	159	174	175	169	146	76
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2015-2016	102	126	139	146	141	132	99	36
B2. Export value growth at historical average minus one standard deviation in 2015-2016 3/	102	131	156	163	157	147	109	39
B3. US dollar GDP deflator at historical average minus one standard deviation in 2015-2016	102	137	164	173	167	157	117	43
B4. Net non-debt creating flows at historical average minus one standard deviation in 2015-2016 4/	102	130	152	158	153	144	106	38
B5. Combination of B1-B4 using one-half standard deviation shocks	102	124	142	149	144	135	101	37
B6. One-time 30 percent nominal depreciation relative to the baseline in 2015 5/	102	180	201	211	204	192	143	52

Table 3. Ethiopia: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2014–34 (concluded)
(percent)

Debt service-to-exports ratio								
Baseline	8	9	9	9	8	9	8	3
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2014-2034 1/	8	8	7	7	6	6	5	2
A2. New public sector loans on less favorable terms in 2014-2034 2	8	9	8	9	9	8	9	4
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2015-2016	8	9	9	9	8	9	8	3
B2. Export value growth at historical average minus one standard deviation in 2015-2016 3/	8	10	10	10	10	10	9	3
B3. US dollar GDP deflator at historical average minus one standard deviation in 2015-2016	8	9	9	9	8	9	8	3
B4. Net non-debt creating flows at historical average minus one standard deviation in 2015-2016 4/	8	9	9	9	9	9	8	3
B5. Combination of B1-B4 using one-half standard deviation shocks	8	9	9	9	9	9	8	3
B6. One-time 30 percent nominal depreciation relative to the baseline in 2015 5/	8	9	9	9	8	9	8	3
Debt service-to-revenue ratio								
Baseline	7	9	9	10	10	10	10	4
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2014-2034 1/	7	8	8	8	7	7	6	3
A2. New public sector loans on less favorable terms in 2014-2034 2	7	9	8	10	10	10	12	7
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2015-2016	7	9	9	9	9	10	10	4
B2. Export value growth at historical average minus one standard deviation in 2015-2016 3/	7	9	9	10	10	10	11	4
B3. US dollar GDP deflator at historical average minus one standard deviation in 2015-2016	7	9	11	11	11	12	12	5
B4. Net non-debt creating flows at historical average minus one standard deviation in 2015-2016 4/	7	9	9	10	10	10	11	4
B5. Combination of B1-B4 using one-half standard deviation shocks	7	9	9	9	9	10	10	4
B6. One-time 30 percent nominal depreciation relative to the baseline in 2015 5/	7	12	13	13	13	14	15	6
<i>Memorandum item:</i>								
Grant element assumed on residual financing (i.e., financing required above baseline) 6/	29	29	29	29	29	29	29	29

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

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

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

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

4/ Includes official and private transfers and FDI.

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

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

Table 4. Ethiopia: Public Sector Debt Sustainability Framework, Baseline Scenario, 2011–34
(percent of GDP, unless otherwise indicated)

	Actual			Average ^{5/}	Standard Deviation ^{5/}	Estimate					Projections			
	2011	2012	2013			2014	2015	2016	2017	2018	2019	2014-19 Average	2024	2034	2020-34 Average
Public sector debt 1/	38.9	33.2	38.3			45.5	51.5	55.3	57.3	57.8	57.1		51.8	41.2
<i>of which: foreign-currency denominated</i>	23.3	18.3	21.4			23.3	27.4	29.8	30.8	30.0	28.9		22.6	11.1
Change in public sector debt	-1.5	-5.7	5.1			7.2	6.0	3.8	2.1	0.5	-0.7		-1.2	-0.5
Identified debt-creating flows	-3.6	-7.4	2.5			7.0	4.2	1.4	0.9	0.7	-1.3		-2.4	-0.8
Primary deficit	2.5	3.7	4.6	3.3	1.7	10.0	8.7	6.3	6.0	6.2	4.1	6.9	2.2	3.0
Revenue and grants	19.3	17.9	18.3			17.8	18.0	17.8	17.6	17.6	17.8		18.0	20.5
<i>of which: grants</i>	5.9	4.2	2.7			2.7	3.6	3.5	3.4	3.4	3.3		3.5	3.2
Primary (noninterest) expenditure	21.7	21.7	22.9			27.7	26.6	24.1	23.6	23.8	21.8		20.2	23.4
Automatic debt dynamics	-5.8	-10.7	-1.9			-3.0	-4.5	-4.9	-5.1	-5.5	-5.4		-4.6	-3.8
Contribution from interest rate/growth differential	-7.1	-6.6	-2.9			-3.2	-4.4	-4.9	-5.1	-5.4	-5.3		-4.5	-3.8
<i>of which: contribution from average real interest rate</i>	-3.0	-3.5	0.0			-0.3	-0.9	-0.9	-1.0	-1.1	-1.2		-1.3	-1.2
<i>of which: contribution from real GDP growth</i>	-4.1	-3.2	-2.9			-2.9	-3.5	-4.0	-4.1	-4.3	-4.0		-3.2	-2.6
Contribution from real exchange rate depreciation	1.3	-4.1	1.0			0.2	-0.1	0.0	-0.1	-0.1	-0.1		...	...
Other identified debt-creating flows	-0.3	-0.4	-0.1			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0
Privatization receipts (negative)	-0.3	-0.4	-0.1			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0
Recognition of implicit or contingent liabilities	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0
Debt relief (HIPC and other)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0
Residual, including asset changes	2.2	1.6	2.6			0.2	1.8	2.4	1.2	-0.2	0.6		1.2	0.3
Other Sustainability Indicators														
PV of public sector debt	...	...	30.9			37.6	43.0	46.5	48.5	49.1	48.7		44.5	36.8
<i>of which: foreign-currency denominated</i>	...	...	14.1			15.4	18.9	21.0	21.9	21.3	20.4		15.3	6.7
<i>of which: external</i>	...	...	14.1			15.4	18.9	21.0	21.9	21.3	20.4		15.3	6.7
PV of contingent liabilities (not included in public sector debt)	...	...	...			...	...	...	...	...	...		...	...
Gross financing need 2/	4.2	5.5	6.8			12.3	11.5	9.7	9.4	9.5	7.4		5.1	4.8
PV of public sector debt-to-revenue and grants ratio (in percent)	...	...	168.8			211.5	239.4	260.7	275.0	278.6	273.9		247.2	180.0
PV of public sector debt-to-revenue ratio (in percent)	...	...	198.1			248.7	299.0	324.8	341.9	344.7	335.7		307.0	213.5
<i>of which: external 3/</i>	...	...	90.0			102.0	131.5	147.1	154.6	149.4	140.8		105.4	38.7
Debt service-to-revenue and grants ratio (in percent) 4/	8.9	10.2	12.2			12.9	15.7	18.9	19.4	19.0	18.9		16.1	8.9
Debt service-to-revenue ratio (in percent) 4/	12.9	13.3	14.3			15.2	19.6	23.6	24.1	23.5	23.2		20.0	10.5
Primary deficit that stabilizes the debt-to-GDP ratio	3.9	9.5	-0.5			2.8	2.6	2.5	4.0	5.7	4.7		3.4	3.5
Key macroeconomic and fiscal assumptions														
Real GDP growth (in percent)	11.4	8.8	9.7	10.9	1.1	8.2	8.5	8.5	8.0	8.0	7.5		8.1	6.5
Average nominal interest rate on forex debt (in percent)	0.8	1.1	1.4	0.8	0.3	1.7	2.1	2.2	2.3	2.4	2.3		2.2	1.7
Average real interest rate on domestic debt (in percent)	-13.6	-21.4	1.2	-10.2	8.1	-1.8	-4.3	-4.3	-4.6	-5.0	-5.2		-4.2	-4.4
Real exchange rate depreciation (in percent, + indicates depreciation)	7.6	-19.4	6.2	-3.2	11.6	0.8	...	...	...	...	...		...	...
Inflation rate (GDP deflator, in percent)	19.8	34.2	5.3	15.8	10.7	7.8	9.5	9.1	9.3	9.5	9.4		9.1	8.7
Growth of real primary spending (deflated by GDP deflator, in percent)	15.9	8.5	15.8	4.1	6.7	31.1	4.0	-1.6	5.9	8.7	-1.4		7.8	7.4
Grant element of new external borrowing (in percent)	...	...	...	...	...	25.7	21.8	22.9	25.6	33.0	34.1		27.2	34.9

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

1/ Public sector includes general government and state own enterprises (Excluding Ethiopian Airlines).

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 excluding grants.

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

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

Table 5. Ethiopia: Sensitivity Analysis for Key Indicators of Public Debt, 2014–34
(percent)

	Projections							
	2014	2015	2016	2017	2018	2019	2024	2034
PV of Debt-to-GDP Ratio								
Baseline	38	43	46	48	49	49	44	37
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	38	38	38	38	36	35	32	28
A2. Primary balance is unchanged from 2014	38	44	51	56	59	63	83	107
A3. Permanently lower GDP growth 1/	38	43	47	49	50	50	47	43
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2015-2016	38	42	45	47	47	46	41	32
B2. Primary balance is at historical average minus one standard deviations in 2015-2016	38	40	42	45	46	46	42	35
B3. Combination of B1-B2 using one half standard deviation shocks	38	39	40	42	42	42	37	29
B4. One-time 30 percent real depreciation in 2015	38	49	52	54	54	53	49	42
B5. 10 percent of GDP increase in other debt-creating flows in 2015	38	51	54	56	56	55	49	40
PV of Debt-to-Revenue Ratio 2/								
Baseline	211	239	261	275	279	274	247	180
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	211	211	216	216	207	200	190	149
A2. Primary balance is unchanged from 2014	211	246	284	316	335	354	462	525
A3. Permanently lower GDP growth 1/	211	240	262	277	282	279	259	211
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2015-2016	211	236	253	266	268	262	230	158
B2. Primary balance is at historical average minus one standard deviations in 2015-2016	211	222	238	255	260	257	234	173
B3. Combination of B1-B2 using one half standard deviation shocks	211	216	225	239	242	238	209	141
B4. One-time 30 percent real depreciation in 2015	211	274	291	304	306	301	275	205
B5. 10 percent of GDP increase in other debt-creating flows in 2015	211	286	306	315	316	308	274	194
Debt Service-to-Revenue Ratio 2/								
Baseline	13	16	19	19	19	19	16	9
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	13	15	16	5	8	5	14	14
A2. Primary balance is unchanged from 2014	13	16	19	24	30	33	55	64
A3. Permanently lower GDP growth 1/	13	16	19	20	19	19	18	13
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2015-2016	13	16	18	18	18	17	14	6
B2. Primary balance is at historical average minus one standard deviations in 2015-2016	13	16	18	10	15	15	14	8
B3. Combination of B1-B2 using one half standard deviation shocks	13	16	17	8	12	12	11	3
B4. One-time 30 percent real depreciation in 2015	13	17	23	24	24	25	24	15
B5. 10 percent of GDP increase in other debt-creating flows in 2015	13	16	23	43	23	30	19	11

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

1/ Assumes that real GDP growth is at baseline minus one standard deviation divided by the square root of the length of the projection period.

2/ Revenues are defined inclusive of grants.



THE FEDERAL DEMOCRATIC REPUBLIC OF ETHIOPIA

STAFF REPORT FOR THE 2014 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

September 5, 2014

Prepared By

The African Department
(In collaboration with other departments)

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FUND RELATIONS

Membership Status: Joined: December 27, 1945

[Article XIV](#)

General Resources Account:	SDR Million	%Quota
Quota	133.70	100.00
Fund holdings of currency	126.20	94.39
Reserve Tranche Position	7.51	5.62
Lending to the Fund		
Holdings Exchange Rate		

SDR Department:	SDR Million	%Allocation
Net cumulative allocation	127.93	100.00
Holdings	97.25	76.02

Outstanding Purchases and Loans:	SDR Million	%Quota
ESF Arrangement	153.76	115.00
ESF RAC Loan	33.43	25.00

Latest Financial Arrangements:

<u>Type</u>	<u>Date of Arrangement</u>	<u>Expiration Date</u>	<u>Amount Approved (SDR Million)</u>	<u>Amount Drawn (SDR Million)</u>
ESF	Aug 26, 2009	Nov 22, 2010	153.76	153.76
ECF ^{1/}	Mar 22, 2001	Oct 31, 2004	100.28	100.28
ECF ^{1/}	Oct 11, 1996	Oct 22, 1999	88.47	29.49

^{1/} Formerly PRGF.

Projected Payments to Fund ^{2/}**(SDR Million; based on existing use of resources and present holdings of SDRs):**

	Forthcoming				
	<u>2014</u>	<u>2015</u>	<u>2016</u>	<u>2017</u>	<u>2018</u>
Principal	3.34	25.40	37.44	37.44	37.44
Charges/Interest	0.01	0.45	0.38	0.28	0.19
Total	3.36	25.86	37.81	37.72	37.63

^{2/} When a member has overdue financial obligations outstanding for more than three months, the amount of such arrears will be shown in this section.

Implementation of HIPC Initiative:Enhanced
Framework

I. Commitment of HIPC assistance

Framework

Decision point date

November 2001

Assistance committed

by all creditors (US\$ million) ^{1/}

1,982.20

of which: IMF assistance (US\$ million)

60.85

(SDR equivalent in millions)

45.12

Completion point date

April 2004

II. Disbursement of IMF assistance (SDR million)

Assistance disbursed to the member

45.12

Interim assistance

10.28

Additional disbursement of interest income ^{2/}

1.54

Total disbursements

46.66

^{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 during the interim period.

Implementation of Multilateral Debt Relief Initiative (MDRI):

I.	MDRI-eligible debt (SDR million) ^{1/}	112.07
	Financed by: MDRI Trust	79.66
	Remaining HIPC resources	32.41
II.	Debt Relief by Facility (SDR million)	

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

^{1/} The MDRI provide 100 percent debt relief to eligible member countries that qualified for the assistance. Grant assistance from the MDRI Trust and HIPC resources provide debt relief to cover the full stock of debt owed to the Fund as of end-2004 that remains outstanding at the time the member qualifies for such debt relief.

Safeguard Assessment

The National Bank of Ethiopia (NBE) was subject to an update safeguards assessment with respect to the ESF arrangement approved on August 26, 2009¹. The update assessment found improved financial reporting and internal audit practices. Notwithstanding these developments, the assessment noted significant weakness and recommendations focused on strengthening oversight of risks and controls, improving accounting records and external audit process, and legal amendments to address safeguards weakness in the Law. As of now, limited progress has been reported on the outstanding safeguards recommendations, particularly legal amendments to strengthen NBE's autonomy. The assessment also noted that a full set of the audited financial statements should be available to the public. However, the NBE does not publish the financial statements on its website, and staff has not yet received audited financial statements for 2012 and 2013, and the management letters issued by the NBE's external auditor. Delivery of this monitoring information by the NBE is required under the safeguards policy. The mission touched upon the outstanding issues and reminded the authorities about key documentation, including the audited financial statements from the NBE, obliged under the safeguards policy.

Exchange Rate Arrangement

The de-facto exchange rate arrangement is classified as a crawl-like arrangement. The authorities describe their exchange rate regime as a managed float with no predetermined path for the

¹ The assessment, completed on December 2009, followed-up on an initial safeguards assessment from September 2001.

exchange rate. The pace of the depreciation of the nominal exchange rate, however, has been stable. The NBE continue to supply foreign exchange to the interbank market based on plans prepared at the beginning of each fiscal year, which take into account estimates of supply and demand. The transaction-weighted average interbank market exchange rate as of July 25, 2014, was Br 19.6649 = US\$1.

Ethiopia maintains four restrictions on the payments and transfers for current international transactions, which relate to: (i) the tax certification requirement for repatriation of dividend and other investment income; (ii) restrictions on repayment of legal external loans and supplies and foreign partner credits; (iii) rules for issuance of import permits by commercial banks; and (iv) 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.

Article IV Consultation

Ethiopia is on the standard 12-month consultation cycle, in accordance with the Decision on Article IV Consultation Cycles (Decision No. 14747-(10/96), 9/28/2010). The last consultation was concluded on September 18, 2013.

Technical Assistance (2010–present)

Department	Purpose	Time of Delivery
AFE	Cash Management and Treasury Single Account	February 2010
AFE	Price Statistics	February 2010
AFE	Risk-based Supervision	May 2010
AFE	Medium-term Expenditure Framework	August 2010
AFE	Stress Testing	November 2010
FAD	Tax Administration	December 2010
AFE	Cash Management	February 2011
STA	Balance of Payments Statistics	March 2011
AFE	National Accounts Statistics	March 2011
AFE	Insurance Supervision	August 2011
FAD	Tax Incentives, Tax Expenditures and Transfer Pricing	December 2011
AFE	Payments System	December 2011
AFE	Strengthening Internal Audit Functions	February 2012
AFE	National Accounts Statistics	March 2012
AFE	Payments Systems	March 2012
AFE	Consumer Prices Index	July 2012
AFE	Modernizing PFM Legal and Regulatory Frameworks	August 2012
AFE	Tax Policy	January 2013
FAD	Reform Review and Tax Policy	March 2013
FAD	Program-based Budgeting	March–April 2013
AFE	Solvency Framework for Insurers	May 2013
AFE	Strengthening MTEF	August 2013
AFE	Cash Management	December 2013
AFE	Revenue Administration	February–March 2014
MCM	Debt Market Development	June 2014
AFE	National Accounts Statistics	June–July 2014

Resident Representative

The IMF has had a resident representative office in Addis Ababa since 1993. The current Resident Representative, Mr. Jan Mikkelsen, took the post in January 2012.

JOINT MANAGEMENT ACTION PLAN, JULY 2014–JUNE 2015

Title	Products	Provisional and actual timing of missions	Expected and actual delivery date
A. Mutual information on relevant work program			
The World Bank work program in the next 12 months	Economic policy analysis and advice		
	• Ethiopia Economic Update (annual)	July 2014–June 2015	Q2 2015
	• Public Expenditure Review	July 2014–January 2015	Q1 2015
	• Growth Study	July 2014–June 2015	Q2 2015
	• Policy dialogue on economic reform issues	July 2014–June 2015	ongoing
	• Poverty assessment	July 2014–June 2015	Q4 2014
	Technical Assistance		
• Capacity Building of the Central Statistical Agency	July 2014–June 2015	Ongoing (until Q2 2017)	
• Public financial management/tax administration	July 2014–June 2015	Q2 2015	
The Fund work program in the next 12 months	Macroeconomic policy analysis and advice		
	• Article IV consultation	May 2015	June 2015
	Technical assistance		
	• PFM	Ongoing	
	• Statistical capacity (national accounts, CPI)	Ongoing	
	• Tax administration	July 2015–June 2015	
B. Mutual information on relevant work program			
Fund request to Bank	• Periodic update on progress on the financial sector capacity building project and social sector projects including poverty related work	Ongoing	
	• Periodic update on all TA activities		
	• Macroeconomic and financial data to be shared regularly		
Bank request to Fund	• Participating in reviews of key analytical work	Ongoing	
	• Periodic update on all TA activities		
	• Macroeconomic and financial data to be shared regularly		
C. Agreement on joint products and missions			
Joint products in the next 12 months	Debt sustainability analysis		June 2015

STATISTICAL ISSUES

I. Assessment of Data Adequacy for Surveillance

General: Data provision is adequate for surveillance. However, in 2013/14 data reported to the Fund were subject to delays and there are data weaknesses and gaps reflecting capacity constraints which the authorities are seeking to address through technical assistance.

National Accounts: Although the authorities are continuing efforts to strengthen the national accounts methodology, deficiencies in the source data and compilation practices affect the accuracy and reliability of the GDP statistics. The reliance on various estimates and surveys remains significant and the weaknesses are particularly evident in respect to the estimation of private consumption, savings, investment and fixed capital formation. The statistical discrepancies between the expenditure categories and output remain large. Information provided to the Fund is subject to frequent revisions and discrepancies. Staff has stressed the need to further improve national accounts statistics and offered technical assistance.

Government finance statistics: Despite recent improvements, government fiscal statistics continue to be affected by shortcomings. Data on the consolidated fiscal operations of government (including public enterprises) are lacking and hinder proper assessment of the overall public sector's borrowing needs and its capacity to repay.

Monetary statistics: Monetary survey for commercial bank is subject to substantial revisions. Timely data collection and reporting continue to be crucial for policy making purposes and the authorities should strengthen efforts to reduce revisions.

Financial statistics: Information gaps about the financial sector have implications for conducting an in-depth assessment of the financial sector health. The mission has not received commercial banks' income statements, information on distribution of non-performing loans, maturity of credit, net open position, and bank-by-bank financial soundness indicators.

Balance of payments: Balance of payments data require improvements in coverage, valuation, timing, and classification of current account transactions. Financial and capital account transactions are also incompletely covered; data on FDI could be better reconciled with alternative sources. The compilation of services, based on the new methodology was not implemented, due to a shortage of staff and a low response rate from information providers.

II. Data Standards and Quality

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 (2006–09) including socio-demographic, macro-economic and financial statistics. No Report on the Observance of Standards and Codes has been completed.

TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE

Table of Common Indicators Required for Surveillance

(as of July 18, 2014)

	Date of Latest Observation	Date Received	Frequency of Data	Frequency of Reporting	Frequency of Publication
Exchange rates	May 2014	June 2014	D	D	D
International reserve assets and reserve liabilities of the monetary authorities ^{1/}	April 2014	June 2014	M	M	M
Reserve/base money	April 2014	June 2014	M	M	M
Broad money	April 2014	June 2014	M	M	M
Central bank balance sheet	April 2014	June 2014	M	M	M
Consolidated balance sheet of the banking system ^{2/}	May 2014	June 2014	M	M	Q
Interest rates ^{3/}	April 2014	June 2014	M	M	M
Consumer Price Index	June 2014	July 2014	M	M	M
Revenue, expenditure, balance, and composition of financing ^{4/} – general government ^{5/}	April 2014	June 2014	Q	Q	A
Revenue, expenditure, balance, and composition of financing ^{4/} – central government ^{5/}	April 2014	June 2014	Q	Q	Q
Stocks of central government and central government-guaranteed debt ^{6/}	2012/2013	June 2014	A	A	A
External current account balance	April 2014	June 2014	Q	A	A
Exports and imports of goods and services	April 2014	June 2014	M	M	M
GDP/GNP	2012/13	June 2014	A	A	A
Gross external debt	2012/13	June 2014	A	A	A
International investment position ^{7/}	...	...	N/A	N/A	N/A

^{1/} Any reserve assets that are pledged of otherwise encumbered should be specified separately. Also, data should comprise short-term liabilities linked to a foreign currency but settled by other means as well as the notional values of financial derivatives to pay and to receive foreign currency, including those linked to a foreign currency but settled by other means.

^{2/} The authorities provide aggregate balance sheet items but not detailed enough for proper financial stability analysis.

^{3/} Both market-based and officially determined, including discount rates, money market rates, and rates on treasury bills, notes, and bonds.

^{4/} Foreign, domestic bank, and domestic nonbank financing.

^{5/} The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.

^{6/} Including currency and maturity composition.

^{7/} Reflecting capacity constraints which the authorities are addressing through technical assistance.



INTERNATIONAL MONETARY FUND



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

IMF Executive Board Concludes 2014 Article IV Consultation with the Federal Democratic Republic of Ethiopia

On September 24, 2014, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Ethiopia.¹

Ethiopia's recent macroeconomic performance continues to be strong, with robust economic growth supported by higher agricultural production, and large public sector and foreign direct investments. Inflation remains contained in single digits and the fiscal stance at the general government level is cautious, although public enterprises continue to provide an expansionary impulse.

The general government budget execution in 2013/14 reflects conservative spending. Recurrent spending is estimated to remain at 7.4 percent of Gross Domestic Product (GDP), and the capital spending-to-GDP ratio will only increase by about 0.3 percentage points to 11.0 percent of GDP. The overall revenue-to-GDP ratio is estimated to fall from about 14.6 in 2012/13 to about 14.1 in 2013/14, mainly on account of decline in nontax revenue which more than offset the tax revenue improvement. The general government budget deficit, including grants, is estimated to be 2.7 percent of GDP in 2013/14, compared to 2.0 percent of GDP a year ago.

Public enterprises continue to borrow heavily from the banking system and externally to finance their investments. The financing of the overall public sector is likely to have been on the order of 10 percent of GDP in 2013/14. Public and publicly guaranteed (PPG) external debt is estimated to have increased to about 23 percent of GDP from 20.5 percent of GDP in 2012/13.

Tight monetary policy has supported achieving the National Bank of Ethiopia (NBE)'s inflation objective in 2013/14. Inflation remained in the single digits throughout the year and was 8.5 percent in June 2014, with food prices rising by 6.2 percent and non-food inflation in the double-digits. Base money, the nominal anchor of monetary policy, increased by 17.5 percent in

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.

April 2014, driven mainly by claims on government (by 19.6 percent) and to a lower degree by claims on non-government (by 11.2 percent).

Developments in the external sector have been mixed, with the deterioration in the trade balance offset by net inflows on services and transfers. The current account deficit is estimated to have widened from US\$2.8 billion (6.0 percent of GDP) in 2012/13 to US\$3.5 billion in 2013/14 (7.1 percent of GDP). It was financed largely by concessional and non-concessional inflows as well as by foreign direct investment (FDI). Substantial inflows on the capital account also facilitated a modest build up in the NBE's reserves. The exchange rate adjusted only gradually, in line with the NBE's managed float policy. While the premium in the parallel market remained modest, the gradual nominal depreciation was insufficient to prevent an appreciation of the real effective exchange rate.

The economic outlook remains encouraging. The 2014/15 budget plan targets the general government deficit at 3 percent of GDP and maintains a strong pro-poor focus. Monetary policy, anchored on base money, is geared toward maintaining inflation in single digits. The public debt to GDP ratio is expected to rise, reflecting large disbursements associated with implementation of investment projects under the Growth and Transformation Plan.

Executive Board Assessment²

Executive Directors commended the authorities for delivering robust and broad-based economic growth, maintaining inflation in single digits, expanding employment and improving social indicators, and welcomed the considerable progress toward the Millennium Development Goals. Looking ahead, Directors observed that the sustainability of the current public sector-led growth strategy was threatened by several downside risks—including, external financing of the public investment program, declining prices for export commodities, and weather-related shocks. Mitigating these risks will necessitate greater policy coherence and appropriate structural reforms going forward, to help shift the balance toward private sector-led, sustainable growth.

Directors underscored the need for continued fiscal prudence in order to achieve the goals of the Growth and Transformation Plan (GTP), while reducing crowding out of the private sector. They called for stepped-up efforts to increase domestic revenue—by broadening the tax base, improving customs and tax administration, and removing tax exemptions. On the expenditure side, Directors welcomed the planned implementation of a new high-level oversight mechanism designed to carefully monitor the operations and financial position of public enterprises and any contingent liabilities. They recommended the adoption of a consolidated fiscal position as a more

² 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. An explanation of any qualifiers used in summings up can be found here: <http://www.imf.org/external/np/sec/misc/qualifiers.htm>.

robust fiscal anchor, and advised that borrowing be done within the context of a comprehensive debt strategy.

Directors concurred that monetary restraint is required in the wake of food and energy price shocks and domestic demand pressures stemming from large public investments. Eliminating recourse to National Bank of Ethiopia (NBE) budgetary financing would also help curb inflationary pressures. Directors also recommended strengthening liquidity management and monetary transmission through enhanced interest rate flexibility and the adoption of a broader set of monetary policy instruments. They noted that a broadened set of monetary instruments would also facilitate further money market development.

Directors called for a strengthening of financial supervisory and regulatory frameworks, to promote inclusion and encourage greater competition. They recommended enhancing private sector credit access by eliminating the requirement that commercial banks hold NBE bills.

Directors encouraged the authorities to improve export competitiveness by reducing overvaluation of the real effective exchange rate through enhanced exchange rate flexibility. A more market-based exchange rate would also facilitate the accumulation of foreign exchange reserves, as a buffer against external shocks.

Directors supported structural reforms designed to create a more enabling environment for private sector investment. In this regard, they recommended developing a proper legal framework for public-private partnerships; simplifying requirements for opening a business; strengthening investor protections; and improving trade logistics.

Directors underscored the need for continued improvement in data quality, including national accounts and financial sector statistics. They welcomed Ethiopia's removal from the FATF blacklist, and looked forward to the completion of the agreed action plan.

Ethiopia: Selected Economic and Financial Indicators ¹

	2011/12	2012/13	2013/14 (Est.)
	(Annual percentage change)		
National income and prices			
GDP at constant prices (at factor cost)	8.8	9.7	8.2
GDP deflator	34.3	4.6	7.3
Consumer prices (period average)	34.1	13.5	8.1
Consumer prices (end period)	20.7	7.4	8.5
External sector			
Exports (U.S. dollars, f.o.b)	14.8	-2.6	9.1
Imports (U.S. dollars, c.i.f)	33.5	4.1	12.7
Export volume	-0.2	9.4	14.7
Import volume	24.5	4.3	13.3
Terms of trade (deterioration -)	7.2	-11.9	-5.0
Nominal effective exchange rate (end of period)	2.8	-5.2	...
Real effective exchange rate (end of period)	19.7	-1.1	...
	(Percent of beginning period stock of broad money, unless otherwise indicated)		
Money and credit			
Net foreign assets	-11.6	3.1	-0.5
Net domestic assets (including other items net)	44.5	21.0	25.6
Broad money	32.9	24.1	25.1
Base money (annual percentage change)	0.4	13.6	16.7
Velocity (GDP/broad money)	3.91	3.64	3.39
	(Percent of GDP, unless otherwise indicated)		
Financial balances			
Gross domestic savings	15.0	16.0	12.8
Public savings	5.7	5.8	3.3
Private savings	9.3	10.2	9.5
Gross domestic investment	33.1	33.0	30.2
Public investment	25.0	24.6	21.7
Private investment	8.0	8.4	8.5
Resource gap	-18.1	-17.0	-17.4

External current account balance, including official transfers	-6.5	-6.0	-7.1
Government finances			
Revenue	13.9	14.6	14.1
Tax revenue	11.6	12.5	13.0
Nontax revenue	2.3	2.0	1.1
External grants	1.7	1.5	1.6
Expenditure and net lending	16.8	18.1	18.4
Fiscal balance, excluding grants (cash basis)	-2.9	-3.5	-4.3
Fiscal balance, including grants (cash basis)	-1.2	-2.0	-2.7
Total financing (including residuals)	1.2	2.0	2.7
External financing	0.9	2.0	1.5
Domestic financing (not including privatization)	0.5	0.2	1.2
Public debt ²	32.7	37.4	44.7
Domestic debt	14.8	16.9	22.2
External debt (including to the IMF)	17.9	20.5	22.6
Overall balance (in millions of U.S. dollars)	-1,067	338	-57
Gross official reserves (in millions of U.S. dollars)	2,262	2,368	2,761
(months of imports of goods and nonfactor services of following year)	2.0	1.9	1.9
GDP at current market prices (billions of birr)	739	853	995

Sources: Ethiopian authorities and IMF staff estimates and projections.

¹ Data pertain to Ethiopian fiscal year from July 8 to July 7.

² Public debt includes general government and state own enterprises (Excluding Ethiopian Airlines).

**STATEMENT BY MR. SAHO, EXECUTIVE DIRECTOR FOR
THE FEDERAL DEMOCRATIC REPUBLIC OF ETHIOPIA
SEPTEMBER 24, 2014**

My Ethiopian authorities are thankful to staff for their constructive dialogue during the Article IV mission. The process has provided an opportunity for an exchange of views on a broad range of topics that will contribute to a refinement of the authorities' macroeconomic objectives set out in the five year Growth and Transformation Plan (GTP) that is being implemented.

Ethiopia is pursuing a path of reforms that, together with the successful implementation of the GTP, are expected to further accelerate growth by increasing productivity and competitiveness, as well as reduce poverty and foster economic diversification. Overhauling the economy will require radically altering the agricultural sector and boosting industry through expanded investment in the sector. The authorities also attribute a high priority to enhancing debt management capacity and strengthening tax administration, areas in which the Fund's technical assistance has been instrumental.

I. ECONOMIC DEVELOPMENTS AND OUTLOOK

The Ethiopian economy has experienced strong economic growth in recent years with real GDP growth at or near double digit levels since 2003/04. This growth momentum has been inclusive and job-creating. Despite a difficult external environment, growth for 2013/2014 is estimated at 11 percent which puts the country among the fast-growing non-mineral economies in Africa. This growth continued to be broad-based, with all sectors contributing, with the agriculture sector at the forefront. The tight monetary policy stance, aided by slowdown in food prices, also saw consumer price inflation at 7.2 percent year-on-year in August 2014. While the current account deficit widened slightly compared to 2012/13 aided by deterioration in the trade balance, the deficit was financed largely by FDI and loans.

The strong growth owes much to the systematic utilization of the limited resources in the growth-enhancing infrastructure sector and the development of pro-poor sectors of the economy such as agriculture, which is the source of livelihood for 84 percent of the population. Current development strategies and policies are geared towards the priority agenda of reducing multidimensional poverty in the country as this is expected to have spillover effects on the overall development of the country. Under this agenda, the government has employed several socio-economic policy instruments, including the agriculture-led development strategy to tackle the productivity challenge in the agricultural sector.

For 2014/15 and beyond, GDP growth is expected to sustain the momentum. As the infrastructural transformation takes place, synergies are being created between the sectors and the rest of the economy. Government's integrated investment in infrastructure is intended to enhance infrastructure development and reduce the current unemployment challenge in the

urban areas. The authorities consider Micro and Small Scale Enterprises (MSEs) development as critical to directly address youth and women unemployment in urban areas. They consider market interlinkages between the MSEs and the mega-infrastructure construction projects equally important to reduce the urban poverty rate and the unemployment levels.

II. FISCAL POLICY

The authorities are aware of the need to pursue fiscal prudence. To this end fiscal policy is geared towards better coordination with monetary policy to combat inflation, while maintaining the momentum of spending on physical and social infrastructure. Fiscal policy also has focused on strengthening domestic-resource mobilization (particularly tax collection) and reducing recourse to central bank lending while, at the same time, increasing pro-poor spending including investment in physical infrastructure. The recently approved budget allocates more than 65 percent of spending to sectors contributing to speeding up the ongoing social and economic development. Domestic revenue collection has been improving in the past several years owing to vigorous tax reform measures, improved tax administration, with the help of technical assistance provided by the IMF, and trade-facilitation efforts.

Going forward, raising fiscal revenues remains an important component of the development strategy focused on public investment. In line with Fund technical assistance recommendations, the authorities expect to broaden the tax base, enhance tax collection, and strengthen institutional and administrative capacities.

Given the overall resource limitations, my authorities intend to facilitate greater participation of the private sector and mobilize a modest level of non-concessional financing while remaining vigilant of the contingent liabilities and debt sustainability implications and strengthening their debt management strategy.

III. DEBT SUSTAINABILITY

The joint debt sustainability analysis undertaken by the Fund and World Bank staffs reaffirms Ethiopia's public and publicly guaranteed debt to be sustainable and that the level of debt distress will not worsen. My authorities also recognize the important role played by the public enterprises, particularly in the improvement of infrastructure critical to socioeconomic development. The completion of the projects under the GTP will lay the ground for higher future growth and enhance the country's capacity to pay its debt.

While maintaining Ethiopia's commitment to sound public finances, the authorities' large investment in infrastructure and social projects has resulted in a rapid increase in public external debt. However, interest rates are on average low and the amortization and grace periods are very long. As a result, external public debt does not breach any indicative threshold under the DSA baseline.

IV. MONETARY POLICY AND THE FINANCIAL SECTOR

Monetary policy was successful in keeping inflation to single digits and supporting the exchange rate. The NBE will continue to gear monetary policy to contain inflationary pressures without jeopardizing the growth momentum. They also plan to augment foreign exchange reserves by US\$300 million by the end of 2014/15.

Although the government's monetary policy allows for flexibility in interest-rate determination, subject to the regulation of a minimum deposit rate of 5 percent, there is, in practice, rigidity in interest rates, which has led to negative real interest rates limiting the effectiveness of monetary policy in demand management. The authorities are committed to maintain macroeconomic stability and bring inflation down further through tight monetary policy to ensure that the real interest rate is close to positive territory.

Ethiopia's banking sector remains well capitalized and liquid. Nevertheless, the NBE has adopted risk-based supervision and regular on-site examination to mitigate any emerging risks. Future priorities of the NBE include refining its operational framework so as to raise the efficiency of the transmission mechanism and promote the development of the interbank market as well as build capacity in crisis preparedness and response. The policy, regulatory and institutional frameworks for microfinance institutions are also well established.

With regard to the NBE bill directive introduced in 2011 requiring banks to allocate 27 percent of total loans disbursed during the month for the purchase of NBE bills was as a result of the very low private banks loan disbursement to long term projects. My authorities consider the arrangement to be instrumental in mobilizing excess bank liquidity for private sector investment. While noting the concerns raised by staff, they will continue to monitor the implementation of the policy with the view of ensuring that resources are allocated for the intended purpose of financing priority sectors without jeopardizing the functioning of the financial sector.

V. PRIVATE SECTOR

The authorities are committed to enhancing the participation of the private sector in growing the economy. Cognizant of the role of the private sector as a key player in the development process, the government continues to formulate policies to ensure that the private sector emerges as a central player in the future development of the country. The currently high infrastructure developments and service delivery improvement by the government is geared towards opening opportunities and creating an enabling environment for the active participation of the private sector. Through a public-private dialogue forum the authorities have addressed some of the issues related to the business climate, including overhauling of customs procedures, and improvements in the business licensing and registration process. The government has also revised several times in the past the investment code to make it more transparent, attractive and competitive.

VI. CONCLUSION

My authorities remain confident that by persevering with the current macroeconomic framework and the continued implementation of the GTP, while addressing any potential risks and challenges, they stand a good chance of mitigating the downside risks identified in table 1 of the staff report. While they do not share some of the conclusions reached by staff as expressed in the staff report under Authorities' views, they nevertheless consider the quality of staff policy advice as useful.