

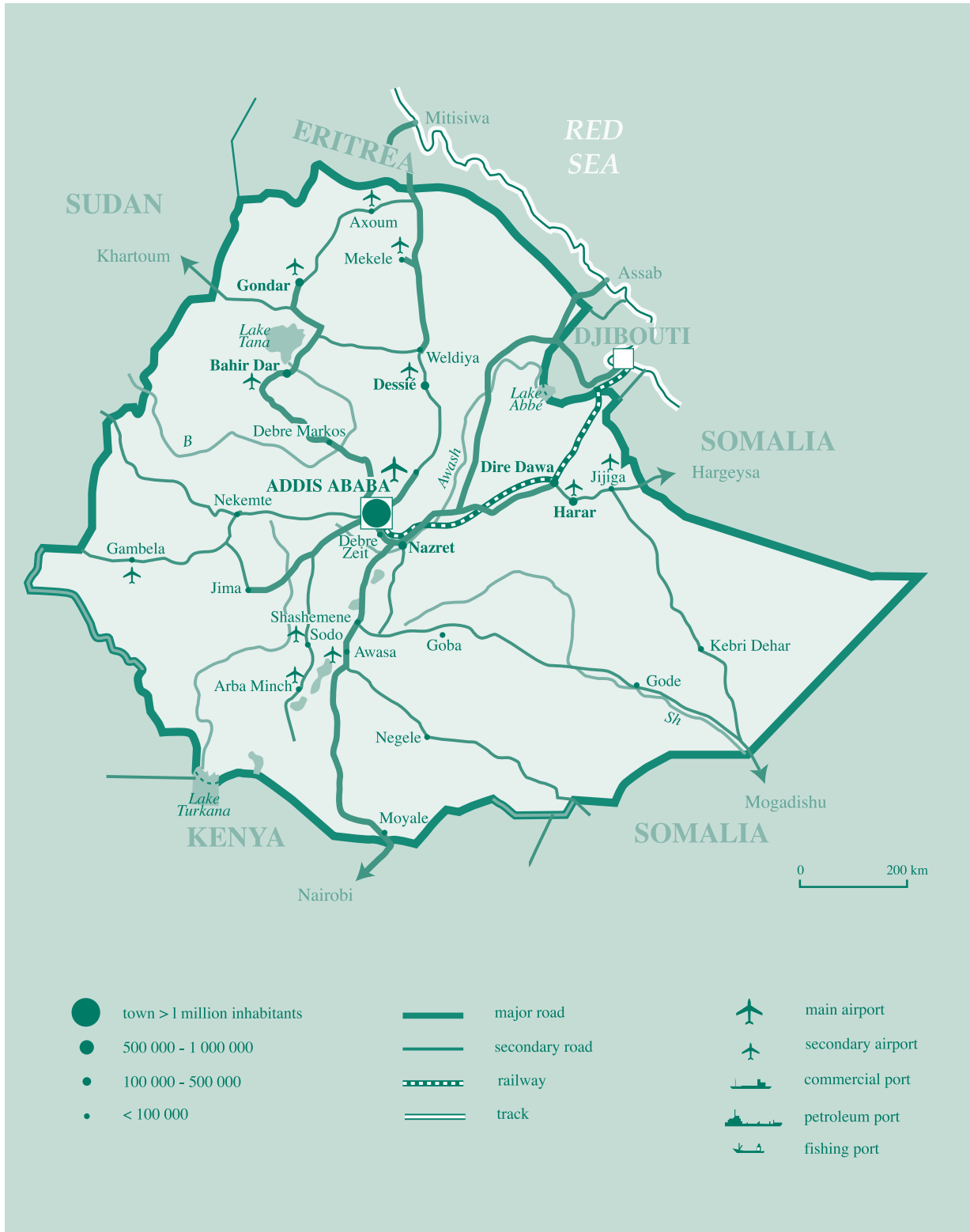
Ethiopia



key figures

• Land area, thousands of km ²	1 104
• Population, thousands (2006)	79 289
• GDP per capita, \$ PPP valuation (2005/06)	794
• Life expectancy (2006)	48.3
• Illiteracy rate (2006)	53.7

Ethiopia



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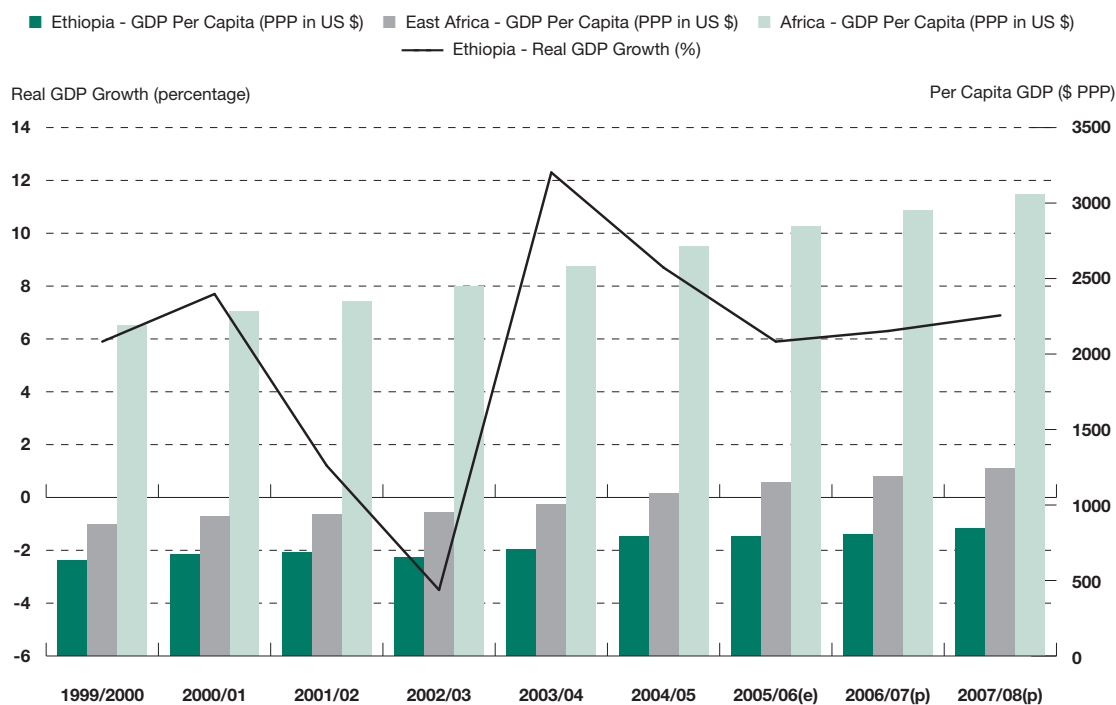
THE ETHIOPIAN ECONOMY has performed strongly in recent years. Growth has averaged an impressive 8.9 per cent over 2004-06, driven mainly by strong agricultural growth along with expansion in industry and services. The economy also benefited from donor-funded investments in infrastructure, ongoing policy reforms, and strong coffee prices. The current growth rate is significantly higher than the average rate of 5 per cent per year recorded over 2001-04, under the Sustainable Development and Poverty Reduction Program (SDPRP). If this growth rate is sustained, Ethiopia will make considerable progress towards achieving the Millennium Development Goal (MDG) of halving income poverty by 2015. This optimistic scenario is threatened by high world oil prices, which are partly responsible for the widening budget and

current account deficits, and the continuing political crisis stemming from the hotly-contested May 2005 election results and its subsequent effect on donor support.

Significant donor-funded investments in infrastructure, policy reforms and strong coffee prices are boosting economic growth but high fiscal imbalances persist.

The government has launched the second phase of the SDPRP, known as the Plan for Accelerated and Sustained Development to End Poverty (PASDEP). The PASDEP is Ethiopia's guiding poverty-reduction strategic framework for the next five years. The objectives of PASDEP are: *i*) annual economic growth of 7 per cent rising to 10 per cent by the end of the programme, through massive investments in key anti-poverty sectors; *ii*) a sustained rise in agricultural productivity and

Figure 1 - Real GDP Growth and Per Capita GDP
(\$ PPP at current prices)



Source: IMF and domestic authorities' data.

<http://dx.doi.org/10.1787/750577841568>

production, with crop output rising from approximately 15 million tonnes per year to 38 million tonnes; *iii*) an emphasis on the textile, leather and floriculture industries, in an effort to boost exports.

Recent Economic Developments

Recent economic developments in Ethiopia have been favourable, despite the ongoing political tensions. Real GDP growth in the 2006 fiscal year was estimated at 5.9 per cent and was due largely to robust growth in agriculture, industry and services. Real GDP growth is projected at 6.3 per cent in 2007, again reflecting strong performances in the industry and services sectors.

Agriculture accounted for 47 per cent of real GDP in 2005/06 and employs about 85 per cent of the population. Agricultural production consists mainly of export products such as coffee, tea and spices and other crops such as cereals, pulses, oil seed, fruits and vegetables. Coffee is the most important export product. Total coffee production was 301 304 tonnes in 2004/05 and is estimated to have increased to 305 000 tonnes in 2005/06. Tea is next in importance as an export product. In 2004/05, tea production amounted to 5 598 tonnes and is estimated to have increased to 5 900 tonnes. It is projected at 6 000 tonnes in 2006/07. Among the food crops, cereal production reached 12.99 million tonnes in 2004/05 and is estimated to have increased sharply to 18.07 million tonnes in 2005/06. All the other crops, namely pulses, oil seed, fruits and vegetables as well as cotton are estimated to have increased in production during 2005/06, over the 2004/05 levels. Production and export of flowers is growing rapidly as new local and foreign local investors have entered the sector, while existing growers are expanding. This new agricultural commodity is generating significant jobs and export revenue. Export earnings have more than doubled to \$20 million in 2005 and have been estimated at \$40 million in 2006 and are projected to reach \$100 million in 2007. Ethiopia's main attractions are its climate, which is highly suitable for floriculture and horticulture, and an impressive scheme of investor incentives and lower freight costs, compared with competitors in Kenya and India.

In spite of the increases in the food components of the agricultural products, food insecurity remains pervasive, requiring improved agricultural productivity through capacity-building, improved input supplies, technology adoption and the provision of infrastructure. During the PASDEP period, particular improvements to rural roads, irrigation systems, and better provision of extension and research services are to be emphasized. Selected small-scale government support for commercialisation will also be provided where there are gaps in private provision.

The *meher* (main) harvest which occurs during the October to December period provides more than 90 per cent of annual agricultural production in Ethiopia. The 2007 harvest is anticipated to be bountiful again due to abundant rainfall in most regions of Ethiopia, as has been the case in the previous three years.

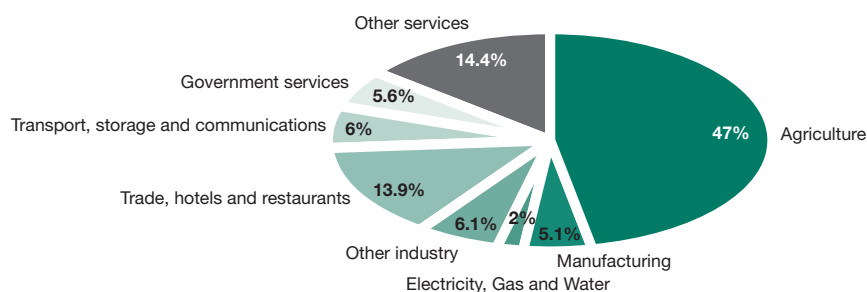
Despite the good harvests, food insecurity continues to be a serious problem in Ethiopia. According to the preliminary results of the Food and Agriculture Organization (FAO), World Food Programme (WFP), Crop and Food Supply Assessment Mission (CFSAM) and the Disaster Preparedness and Prevention Agency (DPPA), the number of people needing emergency food assistance in 2007 is expected to be substantial, although less than the peak of 3.1 million in 2006. The government and humanitarian community are expected to continue providing assistance in 2007 to the 7.3 million or more Ethiopians who are chronically food-insecure through the Productive Safety Net Programme (PSNP).

Achievements under SDPRP in the agricultural sector have included: *i*) an increase in the amount of irrigated land, affecting 200 000 additional farmers; *ii*) the development of livestock through the use of new breeds and types of forage; *iii*) improved grain marketing and the introduction of an inventory and warehouse system; *iv*) promotion of agricultural exports, and *v*) the launch of the National Food Security Programme intended to attain food security for five million chronically food-insecure people and another 10 million are affected by food shortages in drought years.

Funded by the World Bank, the PSN programme is aimed at combating poverty by providing 5 million people in need of help with cash rather than food donations. It is hoped that the programme will boost agricultural productivity and help farmers become more self-sufficient. The second stage of the PSN (PSN-II)

has received funding of \$759 million, including \$150 million from the World Bank, and was set to begin in the first quarter of 2007. The aims of this phase include continued improvement of governance and reduced financial vulnerability to shocks, particularly droughts.

Figure 2 - GDP by Sector in 2004/05 (percentage)



Source: Authors' estimates based on National Institute of Statistics data.

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Industry only accounts for about 12 per cent of GDP but this sector grew strongly in 2005/06, with mining and quarrying, manufacturing, electricity and gas all contributing to growth. Within manufacturing, small-scale and cottage industries grew at a robust 10.8 per cent in 2005/06, compared with 4.8 per cent in 2003/04. Electricity, gas and water also grew by 10.8 per cent in 2005/06, reflecting the development of the Caleb and Shalala gasfields by Petronas (a Malaysian oil firm), which received the concession in 2006. A gas-to-liquid plant and a pipeline to the Djibouti coastline are planned. Petronas is expected to invest \$1.9 billion. In addition, electricity-generating capacity is expected to triple by 2009/10, with access to electric power rising to 50 per cent of the population from the current 17 per cent. To accomplish this, the Ethiopia Electricity Power Corporation (EEPCo) has undertaken the construction of the largest-ever hydroelectric dam in the country on the Omo-Gibe River.

Ethiopia's mineral deposits, including gold, tantalum, iron and nickel, have been under-exploited. Gold nevertheless accounts for a significant part of exports, amounting to more than \$40.7 million in 2003/04. The government also earned more than

\$172 million in the privatisation of the Lega Dembi Gold Mine. Although 24 foreign and local companies have invested \$1.75 billion, exploration activities have been lagging. The PASDEP aims to increase mining exports through higher investment, formalising 85 per cent of unregistered precious metals production, and increasing regional and hydrogeological mapping to enable mineral exploration and infrastructure development.

Telecommunications have expanded greatly over the last few years. Ethiopia has approximately 5 fixed lines per 1 000 persons, one of the lowest in the world. The government has invested heavily in basic infrastructure such as fibre-optic cables, radios and satellites over the last three years. The PASDEP aims to raise the percentage of the population within a 5 kilometre radius access to telecommunications from the current 87 per cent to 100 per cent by 2010. Furthermore, the Ethiopian Telecommunications Corporation has contracted with an association of Chinese firms to expand telephone coverage. The \$1.5 billion plan will run from 2006 to 2010 with the goal of raising the number of mobile phone lines from 1.5 million to 7 million and the number of fixed lines from 1 million to 4 million.

The tourism sector has also experienced robust growth in recent years. Earnings from the tourism industry were \$134.5 million in 2005, an increase of 18 per cent over the previous year. The Ethiopian Tourism Commission hopes to transform Ethiopia into one of the top ten tourist destinations in Africa by the year 2020 and plans to raise the number of visitors to 500 000 by 2010. Tourism recently accounted

for about 13.9 per cent of GDP in 2005/06 and is slated to grow more rapidly in the future. More hotels, restaurants and other tourist facilities are needed. Fortunately, Ethiopia is blessed with many tourist attractions, ranging from unique historical artifacts to religious monuments, as well as other cultural attractions. Tourism has grown at an average annual rate of 13 per cent over the last few years.

Table 1 - Demand Composition (percentage of GDP)

	1997/98	2004/05	2005/06(e)	2006/07(p)	2007/08(p)
	Percentage of GDP (current prices)		Percentage changes, volume		
Gross capital formation	19.6	20.5	17.5	3.0	5.9
Public	13.8	12.1	12.5	6.9	5.1
Private	5.8	8.3	24.9	-2.0	7.0
Consumption	88.3	98.0	5.5	7.2	7.3
Public	10.2	13.8	6.2	4.4	3.6
Private	78.2	84.2	5.4	7.7	7.8
External sector	-7.9	-18.4			
Exports	13.3	15.8	2.1	5.0	5.2
Imports	-21.2	-34.3	10.4	6.9	7.3

Source: Domestic authorities data; estimates (e) and projections (p) based on authors' calculations.

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Domestic demand, especially consumption, has grown strongly over the period 1998-2005, and has entailed booming imports and burgeoning trade deficits. In 2005/06 total gross capital formation recorded a robust growth of 17.5 per cent, with private investment growing especially strongly. Private investment is expected to slump in 2007, however. Although private investment has been increasing in recent years following market-oriented reforms, government investment still accounts for about 60 per cent of total investment. Much of government investment has been financed by donors.

Macroeconomic Policies

Fiscal Policy

The fiscal deficit in Ethiopia has averaged approximately 5 per cent of GDP in the last few years, but in 2005/06 it increased to 7.4 per cent of GDP.

Total revenue decreased from 13.3 per cent of GDP in 2003/04 to an estimated 12.5 per cent of GDP in 2005/06, due mainly to inefficiencies in tax collection. In addition, grants were also reduced considerably due to donor concerns about the recent political turmoil. Government spending, on the other hand, has been growing rapidly in recent years, although it has slowed down from the much higher level registered in 2002/03. Government spending was estimated at 26.3 per cent of GDP in 2005/06. Going forward, the aim of fiscal policy is to restrain the deficit while prioritising poverty-reduction expenditures in the main sectors of health, education and agriculture. The government has enacted a series of tax reforms starting in 2001 to boost tax revenues through improved tax administration and compliance. The 2006/07 budget targets a 16 per cent rise in government spending, to birr 35.4 billion, largely for infrastructure investment. As in previous years, higher spending has been allocated to the priority sectors. As a result, capital spending is forecast to increase slightly from 12.1 per cent of GDP in 2005/06

to 12.2 per cent of GDP in 2006/07, with the largest share of spending going to the *woreda* (local or district) level, followed by regional governments (some of the allocation will be spent on capital projects) and the federal government. The new budget also reflects the redirection of World Bank funding to the *woreda* level through the Protection of Basic Services (PBS) programme. Because of the higher spending envisaged in 2006/07, and coupled with the insufficient generation of domestic revenue and reduced donor inflows, the budget deficit has been projected to be 5.8 per cent of GDP in 2006/07, down from the burgeoning deficit of 7.4 per cent of GDP recorded in 2005/06. The

shortfall in 2006/07 will, as usual, be financed through a mix of domestic and external borrowing. The deficit is forecast to fall back to the still-high 5 to 6 per cent range in 2007/08 and 2008/09 as the government continues with its large-scale capital projects to improve infrastructure. The government will also continue with its high levels of anti-poverty spending, and donor support will be crucial in achieving this objective. Notwithstanding this need, no major scaling-up of donor funds in 2007/08 is expected as the political situation is likely to remain strained, even though support will slowly increase as relations with donors continue to improve in the near-term.

Table 2 - Public Finances (percentage of GDP)

	1997/98	2002/03	2003/04	2004/05	2005/06(e)	2006/07(p)	2007/08(p)
Total revenue and grants^a	17.6	22.8	21.9	20.5	18.9	20.8	20.5
Tax revenue	9.9	12.0	13.3	12.6	12.5	12.4	12.1
Grants	2.4	6.6	4.9	4.6	3.2	5.2	5.2
Consolidated expenditure^a	21.2	29.8	25.1	25.2	26.3	26.6	25.8
Current expenditure	13.5	19.6	17.1	14.3	14.2	14.4	13.9
<i>Excluding interest</i>	<i>12.0</i>	<i>17.9</i>	<i>15.7</i>	<i>13.3</i>	<i>13.3</i>	<i>13.1</i>	<i>12.5</i>
Wages and salaries	4.3	5.8	6.3	6.0	5.7	5.5	5.3
Interest	1.6	1.8	1.3	1.0	0.9	1.3	1.4
Capital expenditure	7.8	9.2	10.1	11.5	12.1	12.2	11.9
Primary balance	-2.1	-5.2	-1.9	-3.7	-6.4	-4.5	-3.9
Overall balance	-3.6	-7.0	-3.2	-4.7	-7.4	-5.8	-5.3

a. Only major items are reported

Source: Domestic authorities' data; estimates (e) and projections (p) based on authors' calculations.

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There is currently no IMF programme in Ethiopia and key donors such as the World Bank are withholding direct budget support to the federal government. Funds will instead be transferred directly to the *woreda* level. Each *woreda* will be allocated funding through a strict monitoring programme, under the supervision of the World-Bank-led PBS project.

Monetary Policy

The current financial sector of Ethiopia consists of the National Bank of Ethiopia (NBE, the central bank), commercial and specialised banks, insurance companies, the Pension and Social Security Authority (PSSA) and saving and credit co-operatives. A number of private commercial banks and insurance companies have

emerged and entered the business since 1994 with the issuance of regulations governing the businesses. At the moment, there are two commercial government banks and one specialised government bank operating competitively with six private commercial banks. In the insurance business, there is one government insurance corporation and eight private insurance companies.

The NBE is the central bank and regulatory authority of financial institutions. It also provides certain commercial bank activities such as holding the accounts of government departments and ministries and facilitating government import letters of credit and foreign exchange business. As the central bank of Ethiopia, the NBE's primary monetary policy aims are to attain relative stability of prices to help protect the

poor from the impact of inflation and to create a stable backdrop for encouraging saving and long-term investment. This involves limiting money growth at a slightly higher rate than nominal GDP.

Inflation stood at 6.8 per cent in 2005 and was estimated at 10.5 per cent in 2006, reflecting high food prices due mainly to rising aggregate demand, despite the good *meher* harvest and the rising costs of inputs and market inefficiencies, as well as fuel-price increases. Inflation is projected to ease to 6 per cent in 2007, due to continued good food harvests and declining international oil prices. In 2006, monetary policy was aimed at achieving prudent growth in money supply as well as maintaining ceilings on domestic government borrowing of about 1 per cent of GDP. However, this became difficult to achieve in view of the government's rising fiscal deficit. Also, the aim of limiting "core non-food" inflation to less than 3 per cent per year could not be achieved due to the lack of co-ordination between fiscal and monetary policies. The NBE therefore had to increase credit to the government to accommodate the large fiscal deficit of 7.4 per cent of GDP in 2005/06. In spite of this, the private sector was not crowded out, as credit to the private sector showed a significant increase in 2004/05 and was expected to keep the same momentum in 2005/06, reflecting strong domestic demand and the ongoing government's infrastructure development and capacity-building programmes.

To make indirect monetary instruments effective and mop up excess liquidity in the banking system, the NBE has instituted measures for the next five years, aimed at encouraging banks to reduce their excess reserves. For this reason, a study intended to address excess reserves was completed in 2005. The NBE intends to continue taking measures to strengthen the inter-bank foreign exchange market and further enhance the financing of the inter-bank money market through elimination of the obstacles that continue to hamper the market's smooth operation.

The amount of foreign exchange transacted in the inter-bank foreign exchange market fell to \$134 million in 2005/06, down from \$138.9 million in 2004/05, due

to a decline in the amount of foreign exchange transacted between commercial banks, because of the financing of the surge in imports by commercial banks. Ninety-two per cent of the total foreign exchange transacted in the inter-bank market during 2006 was made available by the NBE, underscoring the pivotal role that the NBE is playing in providing foreign exchange liquidity to the market, especially for the financing of imports. In the retail market, commercial banks' purchase of foreign exchange from exporters grew 12.8 per cent to reach \$148.8 million, due to improvements in export earnings. Simultaneously, commercial banks' sales of foreign exchange to finance imports increased to almost \$2.8 billion in 2005/06, from \$2.5 billion in 2004/05 and \$1.6 billion in 2003/04. With regard to the foreign exchange bureaux, their purchases of foreign exchange decreased to \$43.5 million in 2005/06 from \$76.6 million in 2004/05, on account of slowdowns in receipts from travel services, and the increasing spread between the parallel and official rates to 3.97 per cent in 2005/06, from 0.68 per cent in the previous fiscal year. In contrast, their sales increased by 96.7 per cent to reach \$31.3 million, which reflects the intention of travellers to buy foreign exchange at low prices from the official market.

A major development that has occurred in recent years in the financial sector is the strengthening of the NBE. The central bank is currently implementing a five-year strategic plan. The main objectives of the bank are to undertake tasks concerning institutional transformation, improving service delivery by the bank, enhancing the soundness of the financial system, making available timely research and policy advice to the government, building an efficient payment system, and enhancing currency management. The NBE has identified the major challenge that needs to be addressed as being the lack of skilled manpower and institutional dynamism. To address this problem, the NBE has instituted a detailed restructuring plan that included a revision of the salary scale in 2004/05. Re-engineering of business processes has also been carried out to improve the Bank's supervisory, regulatory and research capacity, as well as service delivery. In addition, two major divisions of the NBE, namely Government Accounts and the Cash and Foreign Exchange Inspection

Divisions, completed the study and began its implementation. The studies pertaining to all other departments of NBE were nearing completion in 2005 and their implementation is ongoing. In addition to the capacity-building exercise of the NBE, the government is also reforming other aspects of the Ethiopian financial sector. These include strengthening the financial sector infrastructure, developing new financial products, enhancing professional skills in the financial sector and in project implementation and monitoring. The World Bank is supporting this financial sector capacity-building project with a loan of \$5 million.

External Position

Exports are projected to reach an all time high of \$1.08 billion by the end of 2006. Coffee is the dominant cash crop. The volume of coffee exports declined in 2005/06 to 148 000 tonnes from 161 000 tonnes in 2004/05, but rising coffee prices pushed up the value of exports by 5.7 per cent to \$354 million. Earnings from oil seed exports increased from \$82.7 million in 2003/04 to \$211 million in 2005/06 thanks to increasing sales to China. Meat and meat product exports continued to increase, reaching \$18.5 million, up from \$14.6 million in 2004/05. Exports are expected to remain strong through 2007 and 2008. In 2006, the main export destinations were Asia (39.31 per cent), with China accounting for 34.4 per cent, followed by Europe (37.79 per cent) and then by Africa (16.94 per cent). Of the total exports destined for Africa, two neighbouring countries, Djibouti and Somalia, received the highest proportion (60 per cent). Exports to these countries were qat, fruits and live animals.

Imports have been growing more rapidly than exports, resulting in larger trade deficits. Imports are now more than four times the amount of exports, and the former increased to \$4.4 billion (32.3 per cent of GDP) in 2005/06, up from \$3.6 billion in 2004/05 (31.9 per cent of GDP) and \$2.6 billion in 2003/04 (27.3 per cent of GDP) owing to improvements in all components of imports, with the exception of fuel. Imports of raw materials increased 57.3 per cent in 2006, mainly due to the worldwide increase in the prices of steel and iron. Metal prices increased by 45 per cent in 2006 as a result of strong demand and production disruptions. Capital goods imports grew 21 per cent in 2006 to reach approximately \$1.5 billion, reflecting the continued rise in imports of machinery and transport equipment, related to ongoing private investment activities and government capacity-building programmes in infrastructure facilities. In 2006, capital goods imports, on average, generally accounted for a third of total imports. Increases in anti-poverty programmes also led to rising medical and pharmaceutical goods imports. With respect to the origin of imports, more than 50 per cent of Ethiopian imports were from Asia (55 per cent), followed by Europe (29 per cent). Of the total imports from Asia, more than 50 per cent were from China and Saudi Arabia, with imports from the latter consisting mainly of petroleum products (90 per cent).

The higher growth of imports over exports led to a widening in the merchandise trade deficit to 25 per cent of GDP in 2005/06 from 24.5 per cent of GDP in 2004/05. The trade deficit is forecast to rise further to 25.4 per cent of GDP in 2006/07 after which it will fall slightly to 25 per cent of GDP in 2007/08.

Table 3 - **Current Account** (percentage of GDP)

	1997/98	2002/03	2003/04	2004/05	2005/06(e)	2006/07(p)	2007/08(p)
Trade balance	-9.7	-17.1	-20.9	-24.5	-25.0	-25.4	-25.0
Exports of goods (f.o.b.)	7.8	6.0	6.3	7.4	7.3	7.3	7.2
Imports of goods (f.o.b.)	17.5	23.1	27.3	31.9	32.3	32.7	32.2
Services	1.4	2.1	3.3	2.4	2.1	1.0	0.2
Factor income	-0.4	-0.8	-0.7	-0.3	-0.3	-0.3	-0.2
Current transfers	7.0	13.6	13.0	13.7	11.7	11.6	11.5
Current account balance	-1.7	-2.2	-5.3	-8.6	-11.5	-13.1	-13.4

Source: Domestic authorities' data: estimates (e) and projections (p) based on authors' estimates.

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The surplus in net services declined to 2.1 per cent of GDP in 2005/06 from 2.4 per cent of GDP in 2004/05, due in part to slowdowns in net receipts from travel and transportation services. The slowdown in net receipts was due primarily to a fall in the number of international conferences held in Addis Ababa as well as an increase in the number of residents travelling abroad for holiday and business purposes. Net receipts from transportation services declined from \$70.7 million in 2005 to \$43 million in 2006, reflecting an increase in payments by Ethiopian Airlines and Shipping Lines for fuel and port expenses. In contrast, net payments to other services increased by 181 per cent to \$235.4 million in 2006, up from \$83.7 million in 2005, reflecting a significant increase in payments for construction, communication and insurance services.

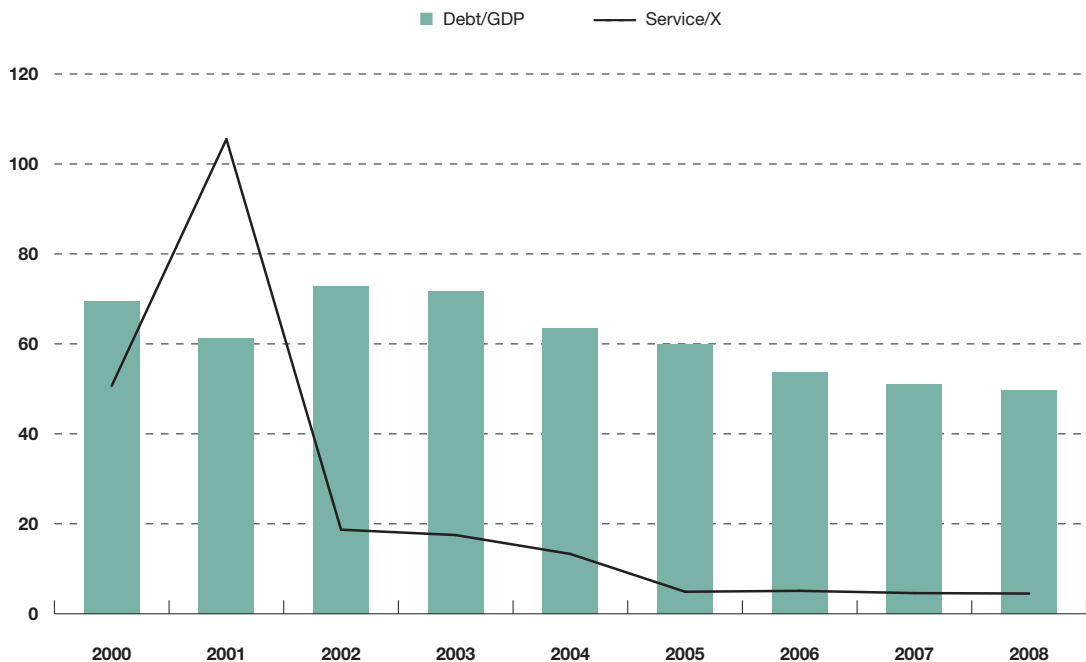
The overall current account deficit is estimated to have widened to a disquieting 11.5 per cent of GDP in 2005/06, up from 8.6 per cent of GDP in 2004/05, reflecting the significant deterioration in the trade balance

as well as a decline in transfers and the slowdown in the surpluses of net services. The current account deficit is expected to balloon to 13.4 per cent of GDP in 2007/08, posing further questions about the sustainability of present macroeconomic and structural policies.

The surplus in the capital account plummeted to \$515.4 million in 2006 from \$570 million in 2005, representing a decline of 9.6 per cent, on account of low long-term loan disbursements, even though there was a marked improvement in principal loan repayments, which were largely due to Heavily Indebted Poor Countries Initiative (HIPC) debt relief. In spite of the decline in the surplus of the capital account, net inflows of foreign direct investment (FDI) increased to \$342.7 million in 2006, compared to \$150 million in 2005. This increase in inflows of FDI contributed to the positive balance of the capital account.

The deficit in the overall balance of payments widened to \$327 million in 2006, up from \$101.4 million in 2005, due to the increase in the

Figure 3 - Stock of Total External Debt (percentage of GDP) and Debt Service (percentage of exports of goods and services)



Source: IMF.

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trade deficit that more than wiped out the impact of the surpluses recorded in transfers, the services account and the capital account. The deterioration in the overall balance of payments shows the importance of the trade deficit in determining the overall balance of payments position of the country.

The five-year PASDEP seeks to bring down the wide trade deficit through the diversification of exports into products such as meat, leather articles and horticulture, while also bolstering traditional exports of coffee, tea and spices. The PASDEP aims to increase the amount of land used for coffee cultivation from 500 000 hectares in 2005 to over 700 000 hectares in 2006, with a resulting 37 per cent growth in coffee production. Similarly, 17 per cent growth is projected for tea and 254 per cent for spices. Oilseed, cut flowers and pulses are also promising new exports.

The PASDEP also seeks to stimulate the inflow of foreign direct investment. For this reason, the government has revised an investment law that reduces the minimum threshold for FDI to \$100 000 for wholly foreign-owned businesses and abolishes minimal capital requirements altogether for foreign investors who export at least 75 per cent of their production

The deterioration in the current account balance of payments put downward pressure on the Ethiopian birr, but exchange-rate movements have been comparatively slight given the continued tight control over currency transactions exercised by the government. In 2006, the weighted average exchange rate of the birr depreciated by 0.34 per cent in the inter-bank market and 3.62 per cent in the parallel market. The spread between the parallel market and the inter-bank market average rates widened to almost 4 per cent in 2006 from 0.7 per cent last year, reflecting increasing fears of devaluation. The premium fell back to 2.4 per cent by the end of June 2006 as the government clamped down on parallel foreign exchange dealers.

As a result of the change in the overall balance of payments from a surplus of \$226.7 million in 2004 to

a deficit of \$327.1 million in 2006, the net reserve holdings of the banking system registered a reserve draw down of \$194.1 million in 2006, compared to a reserve build-up of \$308.2 million in 2004. The reserve draw down was solely due to NBE's reserve draw down of \$275.9 million, which amply offset a reserve build-up of \$81.8 million by commercial banks. The fall in NBE's reserve stock was due to the intervention activity of the NBE in the inter-bank market in order to give banks liquidity, and also make payments for imports of fuel, fertilizer and infrastructure-related equipment. As a result of these transactions, the gross official reserves of the central bank at the end of June 2006 were enough to cover 2.3 months of goods and non-factor services of 2007.

Ethiopia's stock of total external debt fell to \$6 billion in 2005/06 from \$7.2 billion in 2003/04, reflecting relief granted under the HIPC initiative. 80.9 per cent of the total debt was owed to multilateral creditors, followed by bilateral creditors (13.2 per cent) and commercial lenders (5.9 per cent). Ethiopia reached the completion point under the HIPC initiative in April 2004. As a result, Ethiopia will receive further debt relief of \$2.4 billion from the World Bank in July 2007. Reductions in debt service are to be used for poverty-reduction initiatives.

Structural Issues

Recent Developments

The government recognises the contribution that the private sector can make to the overall economic growth and poverty reduction of PASDEP. For this reason, it continues to take measures that will spur the growth and development of the private sector. One of the four main elements of the government's strategy to achieve this objective is strengthening the institutional framework to enable private initiative to thrive. Progressive withdrawal of state entities from areas where the private sector has a comparative advantage, through continued privatisation, fits well into this framework. In line with this framework, the government started a privatisation programme in 1998. The process of

privatising state-owned firms was slow in the initial years. A study commissioned to find out the cause of the slowdown revealed that the two public institutions then existing that were responsible for the programme, the Privatization Agency and the Public Enterprises Supervising Agency, were not co-ordinating well. Following the implementation of the study's recommendations, the two agencies were merged to form the Privatization and Public Enterprise Supervising Agency (PPESA) in July 2004, which is now responsible for the sale of all state-owned enterprises (SOEs). In order to undertake an effective and efficient privatisation programme, PPESA set up different procedures, revised the guidelines for preparing companies for evaluation in terms of making the bid price flexible. This has enabled buyers to quote their own bid prices; however, the agency is the organisation that determines the price of sale. Following these reforms, the participation rate of would-be buyers in the privatisation exercise has increased considerably. During the period 2003-05, 111 state-owned enterprises were offered for sale, most of which were in the industries of food, beverages, garments, leather and shoes, hotels and tourism, printing, construction, textiles and agriculture. In 2006, there were 135 SOEs for sale registered on the books of PPESA. As of May, 13 of the firms had been privatised, 12 of which were bought by local investors and one by a foreign investor. The process has gained momentum and more companies are now being prepared and listed for sale. Among the companies that have been prepared and listed for sale in 2007 are three state-owned agriculture enterprises (Awash Agro Industry Enterprise, Gojeb Agricultural Enterprise and the Horticulture Development Enterprise) and the Assela Malt Factory, the only malt-producing factory in the country.

In order to improve the process, the government has sought to provide a market-oriented, transparent and competitive process, and has permitted the winning bidders to reorganise the labour force of the companies they acquire.

The government has so far limited privatisation to smaller firms such as the Bahir Dar Textiles factories, the Repi Soap factory, and Akaki Textiles.

Utilities and other strategic enterprises such as the Ethiopia Telecommunications Corporation and the Ethiopian Electric Power Company are to remain under state control.

Internal auditors have protested that managers of state companies subject to privatisation have pressured them to produce favourable reports. In response, the government has decided to create a three-member audit committee for each firm, consisting of one of the company's board of directors and two government representatives.

Ethiopia's business climate is ranked relatively favourably in the region, placing it 97th out of 175 countries on the World Bank's 2007 *Doing Business* (DB) index; this is an improvement from its 101st ranking last year. Ethiopia's ranking is particularly good on the DB "paying taxes" sub-indicator, but poor on the "trading across borders" and "registering property" measures. These scores are problematic given Ethiopia's goals of boosting exports and FDI, and indicate that Ethiopia still has a long way to go to improve its business climate.

The government also sees infrastructural development as an essential element in its strategy for accelerating overall economic growth and reducing poverty. For this reason, during the SDPRP period, in the roads sub-sector, priority was accorded to new road construction as well as major rehabilitation/upgrading/maintenance work. Of the targeted 5 637 kilometre road development, 5 561 kilometres were completed, of which 1 276 kilometres were new rural roads. As a result, road density rose from 32.3 km/1 000 square kilometres in 2001/02 to 33.6 km/1 000 square kilometres by the end of the programme. In the power sub-sector, the total electric power generated from the inter-connected and self-contained systems in the last three years increased from 473 megawatts (MW) in 2001/02 to 768.5 MW and 791 MW in 2003/04 and 2004/05, respectively. During the same period, the power generated from self-contained systems increased from 19.99 MW to 22.78 MW. Total length of high voltage transmission lines (230 kilo volt, 132 kilo volt, 66 kilo volt and 45 kilo volt) has increased

from 6 304.22 kilometres in 2000/01 to 6 534.04 kilometres and 7 927 kilometres in 2003/04 and 2004/05, respectively. The length of distribution line has increased from 9 512.9 kilometres in 2001/02 to 13 798 kilometres in 2003/04 and 25 000 kilometres in 2004/05. In the telecommunications infrastructure sub-sector, before the commencement of SDPRP, services were poorly-developed and did not cater for the needs of the rural community.

The situation has started to reverse in recent years, due to steps taken by the government to emphasise network expansion, service improvement and expansion packages. Ethiopia made huge investments amounting to birr 8 billion (\$930 million) in basic multi-media core infrastructure to extend network expansion for woreda-net, cable-net and agri-net projects. As a result, by the end of 2004/05 the number of users had increased to 620 000 for regular fixed telephone lines, 410 630 for mobile phones and 17 375 for Internet lines. Despite this progress in the infrastructure sector, many challenges still remain. The PASDEP programme for strengthening the infrastructure of the country includes building more than 20 000 kilometres of new roads by 2010. In terms of telecommunications, the PASDEP hopes to extend access to fixed telephone lines to 3.2 million people. The cellular mobile telephone network is also to be expanded to 6.8 million people by the end of the PASDEP in 2010. As noted earlier, the electrical system in Ethiopia will also be increased three-fold by the end of the PASDEP, through the construction of five new dams, including the large Gilgel-Gibe III project.

The government is undertaking a series of land reforms in order to encourage individual farmers, pastoralists and agricultural investors to make better use of rural land. The first step in this exercise was the proclamation of land administration law no. 456/2005, which allows peasant farmers/pastoralists who are engaged in agriculture for a living, the right to own land free of charge. The law clarifies land usage rights and allows for the transfer of rights. The law is already being tested in one of the regions on a pilot-scheme basis, whereby 13 million farmers/pastoralists have been given temporary user rights certificates.

Access to Drinking Water and Sanitation

Ethiopia is favoured with a considerable untapped water supply from 12 main river basins as well as 12 sizeable lakes. The total annual surface runoff of these sources of water adds up to about 122 billion m³. Estimates of underground water resources currently stand at about 2.6 billion m³. Nevertheless, more effort needs to be made to develop these water-supply sources so that they can contribute to the reduction of poverty and diseases.

Ethiopian water policy allows all stakeholders the opportunity to participate in improving efficient access to and utilisation of safe water. A comprehensive National Water Resources Management Policy established in 1998 and corresponding strategy introduced in 2000 provide guidance for investment in both rural and urban water supply and sanitation. In 2002, the government prepared a National Water Sector Development Programme and has incorporated a Universal Access Plan (UAP) in its Second Plan of Action for Sustainable Development to End Poverty (PASDEP). The national sanitation strategy outlines the need for participatory learning, advocacy, appropriate technology and reliance on local producers.

A memorandum of understanding has also been signed between the Ministry of Water Resources (MoWR), the Ministry of Health (MoH), and the Ministry of Education (MoE). The memorandum ensures that while the MoWR and the MoH take responsibility for access to and safe utilisation of water, the MoE will promote water and sanitation in schools through the curriculum, the establishment of clubs, the promotion of reliable technologies for water and sanitation, and the education of teachers.

In addition, a National Sanitation and Hygiene Protocol has been implemented to enhance the synergies within the programme's implementation. The sanitation protocol identifies ways to implement hygiene and sanitation elements into the planning and finance strategy. It also deals with co-ordination in the preparation of guidelines, and defining minimum standards and information management.

The government has also established Water Sanitation committees (WatSan). Current WatSan committees have no formal bylaws guiding their activities. A study commissioned in 2006 indicates that the scope of community ownership of WatSan assets is not clearly understood in most of the community-managed systems in Ethiopia. The legalisation of these committees is essential since this will allow them to use formal services such as banking services (access to deposits and loans), and help them to address legal issues.

The successful implementation of water policies has also been based on the application of appropriate low-cost technologies, the manufacturing of low-cost water-lifting devices, the decline in the unit costs of construction, and political leadership from the federal, regional and woreda governments. In addition, the shift from public to local private sector for the construction of wells has contributed to a more efficient system of well production. The cost of hand-dug wells, for instance, has reportedly declined from approximately birr 50 000 to birr 15 000 due to a shift towards involving the local private sector¹. The private sector and civil societies are also involved in rural water services through the establishment of co-operatives under the provision of the Cooperative Society Proclamation.

According to survey results carried out in Ethiopia, 36 per cent of households had access to safe drinking water in 2004, compared to 19 per cent in 1996. Of these households, 12.9 per cent use water from a protected well or spring, 18.8 per cent get their water from a public water tap, while 4.2 per cent have access to their own private water taps.

While 90 per cent of urban households had access to clean water in 2004, only 25 per cent of rural households had access to safe water. Of these rural areas, 32 per cent of family households obtain their water from unclean rivers and lakes, 42 per cent receive their water from unprotected wells, 14 per cent obtain their water from protected springs, and the remaining 10 per

cent use public taps. However, 64 per cent of households in the urban areas have a public tap, while 23 per cent use their own water taps.

It is estimated that 92 per cent of rural households live less than 5 kilometres away from the closest source of drinking water, while around 6 per cent still need to travel an average of 5-9 kilometres in order to obtain water for daily uses. The corresponding accessibility in urban areas is much better. More than 82 per cent can access drinking water within a radius of 1 kilometre. The availability of sources of drinking water within a 5 kilometre radius has not notably changed in recent years. In addition, more than 93 per cent of total households reported no improvement in the sources of drinking water available to them during the past 12 months. However, 19 per cent reported a change during the last five years.

With respect to sanitation, the Ethiopian Ministry of Health (MoH) estimates that Ethiopia has some of the lowest sanitation coverage in the world, placing it at 30 per cent. Furthermore, a detailed water-quality study revealed that fecal matter was present in approximately 40 per cent of collected and stored drinking water samples. Nevertheless, only 3 per cent of these contaminated water supplies were at a level that would present a risk to human health. In addition, 63.9 per cent of the population lives in one room, while 23.8 per cent of households live in two rooms. This issue is all the more detrimental and unsanitary since 63.9 per cent of households have families with 5 to 10 people all living together; 39.5 per cent of these families also have animals living with them.

Ethiopian studies on Knowledge, Attitude and Practice (KAP) reveal that most of the respondents were uninformed and unaware of the causes of diseases or the effects of sub-standard living conditions on their health and well-being. According to the studies, 71.5 per cent of respondents disclosed that they had never received education about the health and hygiene issues pertaining to water and sanitation. 52.7 per cent did not understand the implications of overcrowding, while

1. MoWR, verbal information July 2006.

28.4 per cent could not identify any diseases which were due to poor living conditions.

MoH estimates that 60 to 80 per cent of communicable diseases were due to the lack of basic sanitation services. Personal hygiene has been a critical factor in most rural areas and small towns, due to the lack of soap and acute shortages in the quantity and quality of water. The KAP study revealed that 37.5 per cent of people took a bath at an interval of between 1 and 5 days, 47.7 per cent at intervals between 3 to 30 days, and 14.1 per cent took a bath after 30 days.

The current programme for the elimination of poverty, PASDEP, is expected to enhance access to safe water across the country through capacity-building, adopting low-cost, affordable and labour-intensive technologies, and promoting gender equality in the design and implementation of water projects and programmes. This programme is expected to increase water coverage from 44 to 80 per cent in rural areas and from 80 to 92 per cent in urban areas from 2005/6 to 2009/10. The PASDEP will also target the regions with the lowest supply of water. To increase the supply of rural drinking water, 2 133 deep wells will be constructed, along with 14 908 shallow wells, 101 355 hand-dug wells, 404 ponds, 505 cisterns, 14 surface water sources, and 11 065 spring developments. 48 510 rehabilitation work schemes will also be undertaken. With respect to urban development, study and design for 738 town water systems, construction works for 514 towns and rehabilitation works for 228 towns will be undertaken, in order to provide the essential water services required for private sector development. This will provide 85 per cent of the population with water access, as opposed to an estimated 42 per cent by the end of the SDPRP period 2004-05. The Universal Access Plan (UAP) will also enhance water supply coverage by providing water supplies within 1.5 kilometres for rural areas and 0.5 kilometres for urban areas.

The PASDEP will also provide a substantial programme aimed at promoting the use of latrines. This will increase rural coverage from 17.5 per cent to 79.8 per cent, and urban sanitation coverage from 50 per cent to 89.4 per cent.

Investments in water and sanitation under the PASDEP are estimated at birr 15.6 billion. 77 per cent of this sum will be provided by the government while the other 23 per cent will be shared amongst the private sector and NGOs.

Political Context and Human Resources Development

Ethiopia is a federal parliamentary republic, with the prime minister heading the government. The president holds all executive powers while legislative power is shared by the president and the two chambers of parliament. The judiciary is independent from the other branches. The ruling Ethiopian People's Democratic Revolutionary Front (EPDRF) came to power in 1995. The EPDRF consists of the Tigray People's Liberation Front (TPLF), the Amhara National Democratic Movement (ANDM), the Southern Ethiopia People's Democratic Movement (SEPDM) and the Oromo People's Democratic Organization (OPDO). The EPDRF, headed by Prime Minister Meles Zenawi, has sought to encourage a system of ethnic federalism dominated by nine semi-autonomous regions with the authority to spend or raise their own revenues.

Ethiopia held general elections in May 2005 in which more than 90 per cent of eligible voters participated. The ruling EPDRF won 327 of the 547 seats available in parliament. The Coalition for Unity and Democracy came second with 109 seats. However, the elections were marred by allegations of widespread vote-rigging and intimidation. Nevertheless, the US Carter Center's evaluation of the elections judged that "the majority of the constituency results based on the May 15 polling and tabulation are credible and reflect competitive conditions."

Some opposition supporters carried out street protests and strikes against the results of the elections. Thousands of others were arrested and sent to various detention centres around the country. As of February 2006, hundreds of political prisoners were set to go on trial for a range of offences. Journalists were being held

in custody on charges of defamation while members of the opposition parties were being held on the grounds of treason, genocide and fomenting a coup. These include leaders of the CUD and other members of civil society who are still currently in detention. Trials began in May 2006, but have been proceeding at a very slow pace. The outcomes of the trials are currently unknown. There are concerns that key opposition members may die during trial, inciting new bouts of protests and unrest.

The political climate was relatively stable during 2006, largely because the government was able to negotiate a working agreement with the majority of the parliamentary opposition. The EPDRF signed deals on parliamentary procedure and rules of conduct in June 2006 with the two main opposition blocks, which was an important step towards reconciliation. In a key development, the more radical elements of the original CUD that have refused to join parliament, as a way of expressing solidarity with the position taken by the imprisoned leaders, formed a new opposition grouping in May 2006. This grouping, called the Alliance for Freedom and Democracy (AFD) was formed with outlawed opposition groupings including the Oromo Liberation Front and the Ogaden National Liberation Front, which continue to wage a low-intensity war against the government. The AFD is likely to cause trouble as some of its members may attempt to intensify the armed conflict, even though they lack effective capacity to do so.

In December 2006, the Ethiopian government launched air strikes against fighters loyal to the government of the United Islamic Courts (UIC) in Somalia in support of the weak Somali interim government. Ethiopia has frequently warned that it would protect the transitional federal government in Somalia against the UIC which controlled most of southern Somalia. Ethiopian forces quickly captured the capital Mogadishu and routed the UIC. Ethiopia's involvement in Somalia was justified by fears that a united anti-Ethiopian regime in Somalia may be detrimental to Ethiopia's security. Furthermore, the UIC has been receiving help from the Eritrean government, an antagonist of the Ethiopian

government. Fulfilling its promise that Ethiopian forces would not stay long in Somalia, the government began the first phase of a planned withdrawal on 23 January. Some Ethiopian troops are likely to remain in Somalia for some months to come in the expectation that an African Union (AU) peacekeeping force can be assembled and put in place before complete troop withdrawal. Ethiopia may remain longer than expected in Somalia as an AU force is unlikely to be constituted as quickly as hoped. This could fuel anti-Ethiopian sentiment in Somalia.

There has been no progress on the clash between Ethiopia and Eritrea over the demarcation of the borders. In April 2002, the Boundary Commission otherwise known as the Eritrea-Ethiopia Boundary Commission (EEBC) established by International Court of Justice, awarded some land to both sides. Badme, a key area under dispute was awarded to Eritrea but Ethiopia rejected this decision and both countries have since remobilised their armies along the border, leading to fears that war may be imminent. Military commanders from both armies continue to meet in Kenya under the guidance of the UN Mission to Ethiopia and Eritrea (UNMEE). Meanwhile, the EEBC has given both sides until November 2007 to begin demarcating the border defined by the Commission in 2002, although changes would not be recorded on official maps, irrespective of the official demarcation. However, both sides have refused to comply with the ultimatum.

Corruption is perceived as widespread in Ethiopia. The country ranked 137th out of 158 countries on Transparency International's Corruption Perception Index for 2005 (the latest available). According to expert analysis by the Ethiopian civil service reform programme, the major causes of corruption in Ethiopia are poor governance, lack of accountability and transparency, a low level of democratic culture and tradition, lack of citizen participation, lack of clear regulation and authorisation, low institutional control, extreme poverty and inequality, harmful cultural practices, a command economy during the Derg regime, weak financial management, inadequate accounting and auditing, and a weak legal and judicial system. To fight corruption, the government established

the Federal Ethics and Anti-Corruption Commission (FEAC) in 2001. Since its inception, the Commission has launched a three-pronged campaign (prevention, investigation and prosecution) against corruption. The Commission has achieved some success in the last four years. However, it still faces a number of challenges in pursuing its goal, which includes the lack of skilled work force in all areas of concern, particularly in investigation and prosecution. In addition, the low level of public participation and the absence of a vibrant media to present a balanced report on the ongoing anti-corruption campaign in the country, have also negatively affected FEAC's performance. The Commission has made wide-ranging plans to redouble its efforts in the coming years to mobilise the public and other resources against corruption in a more vigorous and dynamic way. Prevention of corruption will be given top priority as it is seen as the most cost-effective and sustainable way of fighting corruption and impropriety.

The Ethiopian government is currently prioritising improved governance and decentralisation. The National Capacity Building Strategy Programme promotes civil service and judicial reforms, improved democracy and decentralisation. Civil service laws have been implemented to improve the recruitment, selection and promotion of government staff. The judicial reforms include the training of more federal and regional judges and prosecutors. A human rights commission and ombudsmen have been appointed and efforts are being made to strengthen institutions with the establishment of working systems and procedures. The names and qualifications of approved judges have been publicly announced to ensure transparency and judicial independence. A study is underway of human resource planning and training needs assessment. Efforts have been made to increase the participation of the rural population in development, to build a democratic system and to improve operating conditions within an organised administration. A manual has been prepared and published to attract and obtain adequate participation of the public in all matters. Efforts have been made to improve the capacity of officials at the woreda level and to strengthen the organisational structure of woreda administration.

Poverty as measured by food consumption (the food poverty index) declined only moderately from 42 per cent in 1999/2000 to 38 per cent in 2004/05, while poverty rates as measured by income (the head count index) fell sharply in the rural areas from 51 per cent in 1999/2000 to 39 per cent in 2004/05. Urban poverty has declined more slowly. Given the strong performance of the economy and the agricultural sector, it is projected that the head count index will fall to 29 per cent by 2009/10. The failure of food poverty to decline in step with income poverty primarily reflects a substantial increase in the cost of food.

During the SDPRP period, the government placed strong emphasis on the participation of women in the development process since improvements in women's circumstances generally have positive effects on poverty reduction. For this reason, policies and strategies have been formulated to integrate and mainstream gender dimensions in economic, social and political decisions. Progress made in the area of gender so far includes adopting strong measures in gender-responsive goals and targets to decrease the workload of women in order to enable them take part in political and socio-economic decision-making. Progress has also been made in the adoption of the Penal Code that has included strong measures in support of women's rights. Progressive legislation has been passed on women's access to land, credit facilities, and productive resources. Furthermore, encouraging results were achieved by conducting awareness-creation workshops to incorporate gender dimensions in budgetary processes, resource allocation and in building women's capacity to implement strategies.

In terms of healthcare, the government has focused on areas such as malaria, tuberculosis and childhood diseases, as well as HIV/AIDS. The Health Extension Worker Programme (HEWP) seeks to move healthcare delivery from hospitals towards household and village levels. The programme has trained 3 000 women in the provision of sanitation and immunisation services. Some of the healthcare-related investments that have taken place under the SDPRP include *i*) the training of 10 500 nurses and other healthcare professionals, *ii*) the construction of 1 900 new health centres, *iii*) the

immunisation of over 3 million children, and *iv*) greater provision of anti-retroviral treatment (ART) drugs to HIV/AIDS sufferers. By 2004, child mortality rates had declined to 166 per thousand, while infant mortality rates had decreased to 110 per thousand.

The prevalence rate of HIV/AIDS according to the Ethiopia Demographic and Health survey (2005), for the 15-49 age group is estimated at 1.4 per cent, a huge apparent decrease from the 4.4 per cent rate recorded in 2003, but with some uncertainty about the quality of data. UNAIDS estimates that the prevalence rate is in a range of 0.9 to 3.5 per cent. Forty-two per cent of HIV-positive pregnant women are currently receiving ART drugs. Advanced AIDS patients receive drugs under the Social Mobilization Strategy against HIV/AIDS; 94 per cent of patients have been provided with the drugs at no cost.

The National Education and Training Policy was established in 1994. EDSP III is a programme that

focuses on providing universal primary school education by 2015, with interim targets for 2010 of 86.6 per cent primary enrolment and 63.8 per cent secondary enrolment. Current net enrolment rates (2004) in primary and secondary schools stand at 46 per cent and 25 per cent respectively.

According to the Household Income Consumption Expenditure Survey 2004/05 (HICES), urban unemployment averaged 26 per cent, and ranged up to 40 per cent in the larger urban centres such as Addis Ababa. The Urban Development Strategy in the PASDEP aims to reduce unemployment to less than 20 per cent through vocational and training programmes and through support to small and microenterprises. Furthermore, microfinance institutions will be encouraged to provide funding to the unemployed. Finally, labour-intensive public work programmes are to be developed to employ the urban poor.