Table 1. Eritrea: Selected Economic and Financial Indicators, 1996-2003

	1996	1997	1998	1999	2000	2001 Prel.	2002 Prel.	2003 Proj.
	(Annual percentage change, unless otherwise specified)							
National income and prices								
GDP at constant factor prices	9.2	7.7	3.9	0.3	-12.0	8.7	-1.2	5.4
Consumer prices (end of period)	...	7.7	9.0	10.6	26.8	7.7	23.8	14.0
Food	...	7.9	20.3	12.9	31.5	5.2	17.9	14.0
Non-Food	...	7.6	-0.7	8.2	21.8	10.7	30.4	14.0
External trade								
Exports, f.o.b. (in U.S. dollars)	18.2	-43.8	-47.3	-28.6	82.6	-45.7	160.0	-32.2
Imports, c.i.f. (in U.S. dollars)	27.2	-3.7	6.5	-6.1	-4.9	14.1	-0.6	7.7
Money and credit (end of period)								
Broad money (including foreign currency deposits) 1/	18.7	30.6	18.2	40.9	13.0	26.4	18.5	26.6
Velocity (GDP/average broad money)	1.3	1.22	1.08	0.88	0.76	0.79	0.73	0.73
Interest rate (savings deposits; in percent)	6.0	6.0	6.0	6.0	6.0	6.0	5.0	...
	(In percent of GDP, unless otherwise specified)							
Central government operations								
Total revenue	31.2	40.7	30.5	31.7	34.0	25.6	25.4	25.8
Total expenditure	56.7	51.4	76.3	91.4	66.7	58.5	57.3	50.1
Of which: defense	21.1	12.7	35.0	37.2	35.8	24.2	23.3	18.1
Overall fiscal balance (excluding grants)	-30.1	-11.4	-47.4	-62.1	-31.5	-52.5	-42.5	-43.7
Overall fiscal balance (including grants)	-19.4	-5.6	-38.0	-53.9	-32.1	-34.8	-30.1	-24.4
Domestic fiscal balance 2/	-17.8	-1.5	-30.2	-41.3	-25.5	-21.6	-20.8	-13.6
Financing	18.0	8.1	37.2	53.2	32.5	32.3	30.4	24.4
External	1.2	4.1	3.7	8.7	8.6	13.5	10.2	6.9
Domestic	16.8	4.0	33.5	44.5	23.9	18.8	20.2	17.4
Central government domestic debt (net)	31.7	30.5	58.2	96.7	125.9	119.9	123.2	116.6
External sector								
Current external balance (excluding official transfers)	-19.5	-5.4	-31.5	-38.4	-32.0	-35.4	-27.8	-29.3
Current external balance (including official transfers)	-7.3	2.1	-23.6	-27.9	-16.2	-18.4	-15.4	-10.4
External public debt 3/	6.7	11.0	18.8	37.5	51.4	60.8	78.6	76.4
Debt service/exports (in percent) 4/	0.0	0.3	0.8	5.7	3.8	5.3	15.1	12.9
	(In millions of U.S. dollars, unless otherwise specified)							
Overall balance of payments	53.5	146.7	-174.1	-14.7	-15.2	7.2	-39.0	1.5
Gross international reserves	126.2	243.3	69.0	54.3	36.6	50.6	33.1	30.5
(in months of imports of goods and services)	2.7	5.0	1.4	1.1	0.9	1.1	0.7	0.6

Sources: Eritrean authorities; and staff estimates and projections.

1/ Figure before 1997 excludes currency outside banks in Eritrea.

2/ Total revenue less expenditures excluding, external interest, humanitarian assistance, ERP, demobilization, and other externally financed outlays.

3/ Public and publicly guaranteed debt, including projected new debt.

4/ Three-year average of exports of goods and services used.

Statement by Ismaila Usman, Executive Director for Eritrea
May 2, 2003

Key Messages

- Eritrea, a post-conflict country in transition faces numerous economic and political challenges.

- Eritrea is currently facing the worst drought in its history. Thanks to the ongoing efforts by the international community including multilateral institutions and bilateral donors towards addressing the problem as well as towards facilitating the demobilization and reintegration process of combatants, to help establish lasting peace.

- Assistance, thus far, however, has fallen short of meeting the immediate needs associated with the drought. Similarly, the demobilization and reintegration process is being delayed in part due to inadequacy of financial resources.

- The role of the international community is critical in providing the impetus to steer Eritrea beyond the post-conflict phase and transitional process toward poverty reduction and sustainable growth in both the short-term and over the medium term.

- In this connection technical assistance (TA) is another important and critical component to help address institutional, human, legal and other capacity constraints facing the country.

Introduction

The country has experienced the worst drought since 1993, and continues to suffer from extensive destruction of infrastructure and widespread dislocation of large sections of the population resulting from the border conflict with Ethiopia during 1998-2000. Despite the above, progress is being made in stabilizing and reconstructing the economy, reducing the size of government and its involvement in the economy, especially in the banking sector, where more competition is gradually making foreign exchange transactions market determined. Efforts have been made to restore relations with donors to facilitate commencement of an economic program that could be supported by the Fund. The implementation of a tax reform package in October 2001 fell short of understandings reached with staff, however, the authorities have expressed renewed interest in resuming discussions on an economic program that could be supported by the Fund.

2. Recent Macroeconomic developments

Eritrea's macroeconomic performance has faced severe imbalances as well as a prolonged suspension of budgetary and balance of payments assistance from donors, because of concerns about political governance. The suspension of critical donor assistance has also impaired reconstruction efforts. The border conflict with Ethiopia has led to a slow implementation of the demobilization program, thereby impacting adversely on economic recovery and development. The drought negatively affected economic growth resulting in rising inflation in 2002, with real GDP falling to 1.2 percent. Delays in demobilization and the demining of agricultural land also led to a fall in crop production to about 77 percent. Strong activity in the construction and trade sectors however led to an increase in nonagricultural growth by over 6 percent. Supported by the large depreciation of the local currency and strong growth in monetary aggregates, food prices increased by 18 percent, reflecting a growing shortage of food. Non food inflation on the other hand, increased by more than 30 percent.

a. Fiscal developments

Notwithstanding the adverse impact of the drought, progress was made in some areas. Fiscal policy in 2002 was less expansionary, although a large increase in domestic financing was required to cover the government deficit. As a result of the large expansion of capital expenditures to reconstruct the economy, the overall deficit, including grants, amounted to 30 percent of GDP, as compared to 35 percent in 2001. This however, reflected a sharp reduction in capital spending that was necessary due to lower external financing. The fiscal deficit remained unchanged at 21 percent reflecting the impact on domestic resources. Specifically, revenue performance improved on account of tax system reforms and enhancements in tax administration, while some progress was also made on public expenditure management. Delays in demobilization and a doubling in allowances for combatants and people in the National Service led to an increase in current expenditure by about 7.25 percent of GDP.

b. Monetary and Exchange Rate developments

Broad money grew by 18.5 percent, due to strong expansion of credit to the government, Interest rates however remained stable in nominal terms, but real interest rates turned negative as inflation increased. The easing of monetary conditions at the end of 2002, by reducing reserve requirements also did not help matters. In this connection, my authorities agreed with staff on the need to tighten up and to curb inflation and restore interest rates to positive levels. As staff rightly observed, progress in these areas will require that Fund TA be obtained to enhance institutional and human capacity building. The authorities look forward to the Fund's response in this regard.

In 2002 the external current account deficit remained at an unsustainable level resulting in low level of official reserves. This led to a sale of gold by the BE in the open market, amounting to US$10.3 million, or 1.6 percent of GDP to mitigate the situation. The precarious international reserves position and the virtual fixing of the official exchange rate, caused the differential between the parallel market and the official rate to widen markedly. While my authorities agree with staff on the need to reform the exchange system, without a significant improvement in the foreign reserves situation it would be difficult to achieve an early unification of the rates. They remain committed however to doing everything possible to accelerate the process. In this connection also they intend to request for Fund TA as recommended by staff to develop operational modalities.

c. Structural Reforms Undertaken

On structural reforms, my authorities have taken numerous positive steps including by introducing reforms to customs and reducing effective import tariff rates considerably. As a result, the trade restrictive index dropped from a rating of 6 to 4 and the average tariff rate declined from 18.5 percent to 9 percent. In addition, the top tariff rate was reduced from 200 percent to 25 percent, and the number of bands from 12 to 3. These measures along with others have rendered Eritrea's trade regime among the most liberal in Africa. My authorities' are committed to deepening structural and institutional reforms in order to enhance the responsiveness of the economy

On banking sector reform, the first on-site inspection of the loan portfolios of the three domestic banks were conducted in 2002, by the Bank of Eritrea. The inspections revealed several problems with the management and administration of banks. The banks have been instructed to develop action plans to implement the recommendations of the inspection reports. External audits of the banks are ongoing, to be followed by full fledged on-site inspections. Also, as an interim measure, additional efforts are being made to strengthen the data reporting system for effective off-site surveillance of banks.

3. Policies for 2003

My authorities are aware of the seriousness of the macroeconomic imbalances facing the country, and therefore have no fundamental disagreement with the recommendations made by staff. The year 2003 is regarded as a period of transition, during which my authorities intend to provide clear signals about their commitment to macroeconomic stability and to lay the foundation for a more normal conduct of macroeconomic and development policies. It need however be recognized that the lack of donor financing would lead to a continuation of balance of payments pressures and hamper growth and development because of continued shortages of foreign exchange. My authorities urge the Fund to facilitate an early re-engagement of donor assistance to be complemented by Fund resources and TA to help them to address the challenges facing the economy.

a. Fiscal Policy

My authorities fully agree that the deficit level over the past four years is not sustainable, and they are committed to reducing it to manageable levels, and they urge that their efforts be complimented with financing and grants from donors and multilateral institutions including the Fund. In the 2003 austerity budget the authorities hope to reduce expenditure from levels close to 40 percent of GDP in 2001 and 2002 to 22 percent of GDP in 2003. Defense spending would be cut by half, as a result of the planned implementation of the demobilization program that would release some 130,000 combatants in 2003. Also, foreign funding for capital expenditures is assured.

In 2003 the planned sale of government owned houses and the privatization of some hotels is expected to boost revenue when budget deficit is projected to drop from about 21 percent of GDP in 2002 to 6.5 percent of GDP in 2003, while the overall deficit, including grants, would be reduced from 30 percent of GDP in 2002 to about 24 percent of GDP in 2003.

b. Monetary and Financial Sector Policies

Monetary policy is aimed at reducing the fiscal deficit and curtailing its bank financing. To avoid distortions in financial intermediation, interest rates on bank lending will be restored at positive levels. To ensure better monetary management, the BE will develop a coherent and transparent monetary policy framework as well as a clear strategy for the rational use of its policy instruments with well defined objectives. However, my authorities will continue to request technical assistance support from the Fund to build capacity and institutional development on which such progress depends

To achieve more competition in the financial sector, my authorities would encourage the entry of new banks, including fully foreign-owned banks. More effort will be made towards the establishment and strengthening of the supervision framework to enforce banks' compliance with key prudential ratios, increase the transparency and accountability of their operations, and ensure the adoption of international accounting practices.

4. Medium Term Outlook

Public sector domestic debt is expected to increase, reaching 131 percent of GDP in 2008. In line with the drawdown of existing loan commitments, the level of external debt as a percent of GDP will rise over the period 2003-05 to almost 90 percent of GDP, but would decline thereafter, to about 85 percent of GDP by 2008. The NPV of both external debt and external debt service, as a percent of exports of goods and services, will also increase initially and then begin to drop by the end of the projection period. The implementation of the demobilization program will release 130,000 combatants by end-2003, and the residual 70,000 by end-2004. This will lead to an increase in labor supply to the productive sectors of the economy and raise donor funding for demobilization. Political governance issues are being seriously addressed to enable donors resume their budgetary and balance of payments assistance. Also, the authorities intend, with resumed donor financing and therefore improved foreign exchange inflows, supported by appropriate reforms and stability in macroeconomic policies, to achieve unification of the current dual exchange rate.

The combination of improved macroeconomic performance and higher donor financing will significantly strengthen the sustainability of the public finances. The domestic fiscal deficit will drop to about 5.5 percent of GDP by 2008, compared with more than 15 percent under the baseline scenario. Over the period 2003-08, the overall fiscal deficit will decline by about 16 percentage points to 8 percent of GDP.