- Reports have emerged of an outbreak of Avian flu in a poultry farm in the south of the country. These have yet to be officially confirmed and staff will continue to monitor developments.

- To date, 90 of the 109 elected opposition parliamentarians have taken their seats. UN reports indicate that tension on the Eritrean border has decreased. Ethiopia’s main donors have reconfirmed that they are continuing to provide project aid, while reiterating that a resumption of direct budget support will require progress in addressing concerns over political governance and human rights.

No further information has been received regarding the remaining current account restrictions inconsistent with Article VIII section 2(a) and staff are not recommending approval of such restrictions at this time.

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May 2, 2006

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IMF Executive Board Concludes 2005 Article IV Consultation with the Federal Democratic Republic of Ethiopia

On March 17, 2006, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Federal Democratic Republic of Ethiopia.[1]

Background

Ethiopia continues to pursue its development strategy aimed at achieving the Millennium Development Goals. However, it faces political uncertainties, both from unresolved tensions stemming from the May 2005 national elections, and over the border demarcation with Eritrea, which are impacting donor support. Ethiopia's largely agricultural economy also remains vulnerable to climatic shocks, which have resulted in wide swings in output with severe effects for the poor. Even after two successive years of good harvests, and favorable prospects for 2005/06, the total number of people identified as requiring humanitarian assistance in 2006 is estimated at 11 million.

In 2004/05, the economy grew by 8.8 percent, the second year of rapid expansion after the recent drought. The average annual consumer price inflation rate declined to 6.8 percent in 2004/05, from 8.6 percent in 2003/04, although the year-end rate rose to 13 percent. While the nominal exchange rate against the US dollar remains highly stable, the trend of real

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

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depreciation experienced in 2004/05 reversed during early 2005/06, reflecting a relative strengthening of the US dollar, and a pick up in Ethiopia's inflation. The National Bank of Ethiopia's (NBE) gross reserves rose during 2004/05 to the equivalent of 3.9 months import cover, but have declined in the first 5 months of 2005/06.

The government's domestic borrowing rose to 3.5 percent of GDP in 2004/05—2 percent of GDP higher than budgeted—as a result of shortfall in revenues and aid inflows, and the stock of government's domestic debt remained high at 35 percent of GDP. Capital spending rose sharply as the government began to scale-up domestically-financed spending on infrastructure, which was reflected in an increase in overall poverty spending.

Broad money growth in 2004/05 and through November 2005, was entirely due to an expansion of net domestic assets, including sharp increases in credit to the private sector and public enterprises. At the same time, commercial bank's excess reserves rose to over 30 percent of deposits as the NBE met government financing needs, and the dominant Commercial Bank of Ethiopia (CBE) sharply reduced its holdings of treasury bills. The external current account deficit (after official transfers) widened to 9.1 percent of GDP in 2004/05, in spite of export growth of 36 percent. Imports rose by 40 percent, or about US$1 billion. About a third of this increase reflected higher fuel costs.

Ethiopia has continued to implement its financial restructuring program, and met the plan's 2004/05 non performing loan and capital adequacy ratio targets for the CBE. Progress has also been made on strengthening public expenditure management. Ethiopia secured debt relief from the IMF under the Multilateral Debt Relief Initiative in December 2005. It reached the completion point under the enhanced Heavily Indebted Poor Countries (HIPC) Initiative in April 2004.

Executive Board Assessment

Executive Directors welcomed the recent strong growth performance, led by an improvement in the agricultural sector. However, they emphasized the need to maintain a stable macroeconomic framework, and in that regard, noted the importance of containing inflation and emerging pressures on the balance of payments. Looking ahead, the main challenge will be to sustain strong growth to meet the development objectives and to reduce poverty. Directors recommended that the authorities begin to set the stage for the evolution of a vibrant private sector that will complement the state's own economic development efforts. They stressed the importance of accelerating the structural reform agenda, in particular in order to raise agricultural productivity and boost private sector growth. The resumption of the privatization program and introduction of a competition policy are steps in the right direction in this regard, but they need to be supported by a strengthened legal and regulatory framework.

Directors considered that significantly higher levels of external assistance will be required to sustain growth at levels that would reduce poverty—which remains widespread—and meet the Millennium Development Goals (MDGs). They welcomed the presentation of a scenario laying out the financing requirements as well as the policy challenges for meeting the MDGs.
They stressed that, in line with the Monterey Consensus, donor efforts will need to be complemented by a sound development strategy and strong governance systems.
Directors encouraged the authorities to engage in a constructive dialogue with all concerned

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parties to resolve outstanding political issues and generate the conditions for a resumption of donor budget support. They also stressed the need to strengthen public expenditure management and ensure that aid and resources set free by the Multilateral Debt Relief Initiative are used in an efficient and macroeconomically sound manner.

Directors agreed that improving Ethiopia's infrastructure will be essential to enhancing its growth prospects. However, scaling up domestically financed investments by public enterprises risks jeopardizing the balance of payments position and macroeconomic stability. Against this background, Directors welcomed the authorities' decision to postpone some public enterprise infrastructure imports and their commitment to take additional measures, as necessary, to ensure an adequate level of international reserves. At the same time, administrative controls should be avoided as they could have an adverse impact on the private sector.

Directors recommended that fiscal policy should support monetary policy in containing inflation and be focused on limiting domestic bank financing and ensuring debt sustainability. They welcomed the expenditure cuts introduced this year, as well as the proposal to pass through higher oil prices to consumers by reducing the domestic fuel subsidy—stressing the need to implement this promptly. Nevertheless, a tighter fiscal stance might be required to contain demand and to stabilize the balance of payments. Directors also saw a need to better prioritize expenditures, with the objective of strengthening pro-poor spending and establishing an effective social safety net, while improving public expenditure management. Looking further ahead, domestic borrowing should be reduced in order to contain debt levels and provide room to respond to unexpected shocks. Efforts are also needed to improve the buoyancy of the tax regime to ensure that revenue growth keeps up with the growth of recurrent expenditures.

Directors supported the authorities' request for technical assistance from the Fund in the area of tax and customs policy, including on the structure and level of tariff exemptions. They noted the importance of ensuring a non-discriminatory tax and tariff structure to encourage private sector development and foreign direct investment.

Directors called for the close monitoring of large public enterprises, and urged the authorities to move in the direction of incorporating the activities of these enterprises into the consolidated fiscal accounts to help illuminate the fiscal risks stemming from the government's on-lending of external financing to public enterprises and its guarantees on domestic borrowing by public enterprises. Directors stressed that the debt of public enterprises and the government's contingent liabilities should be fully taken into account in a comprehensive debt management strategy.

Directors called for a tightening of monetary policy. They observed that the high level of commercial bank excess reserves—most of which are held by the state-owned Commercial Bank of Ethiopia (CBE)—constrains the use of indirect monetary instruments. In this context, Directors agreed that, at the current stage of development of the monetary system, imposing a direct ceiling on the CBE's credit operations would be the most reliable means of guarding against excessive credit expansion without compromising credit extension to the private sector, which remains at a relatively low level.

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Directors agreed that external competitiveness is adequate, and that the current managed floating exchange rate system has served Ethiopia well. At the same time, they saw scope for increased flexibility to allow the exchange rate to reflect balance of payments developments going forward.

Directors welcomed the signs of improvement in the financial sector, with a steady decline in nonperforming loans and a general strengthening of capital adequacy ratios. At the same time, prudential supervision of the banking system needs to be strengthened. Directors called for further financial sector reforms over the medium term, aimed in particular at increasing banking sector competition, in order to support the efficient allocation of financial resources in the economy, encourage the development of the private sector, and boost long-term growth prospects.

Directors commended the authorities for their commitment to maintain a close relationship with the Fund. They looked forward to further discussions of how the Fund could best contribute to the achievement of the authorities' economic objectives in the period ahead.

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