Ethiopia

key figures

- Land area, thousands of km² 1 104
- Population, thousands (2004) 72 420
- GDP per capita, $ (2002/2003) 94
- Life expectancy (2000-2005) 45.5
- Illiteracy rate (2004) 56

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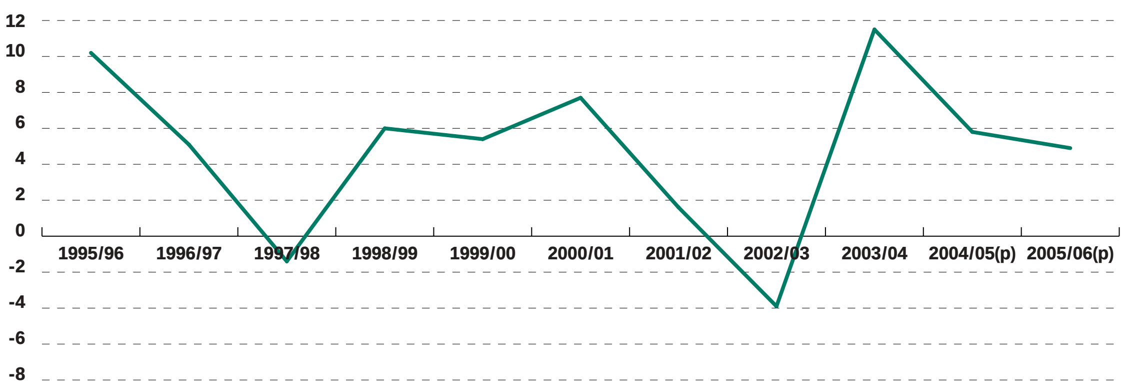
Ethiopia

SHORTLY AFTER THE COSTLY CONFLICT with Eritrea ended in December 2000, Ethiopia was hammered by a series of droughts, increasing already high levels of poverty and requiring massive imports of food aid. The economy made a promising recovery in 2003/04, growing at an estimated 11.5 per cent. Preliminary estimates indicate real GDP growth for 2004/05 in the range of 5.6 to 6 per cent. Inflation has been reduced from over 15 per cent during the last fiscal year to below 10 per cent in 2003/04. Ethiopia continues with the successful implementation of its Sustainable Development and Poverty Reduction Programme (SDPRP), formally adopted in 2002. The core objective of the SDPRP is to promote pro-poor and rapid growth through *a)* proactive development policies; *b)* targeted public interventions; and *c)* an enhanced incentive structure. Based on donors' endorsement of the SDPRP, the government hopes to double the inflow of aid. Ethiopia reached the completion point under the enhanced Heavily Indebted Poor Country (HIPC) initiative in April 2004, which is expected over time to provide the country with nominal debt relief in the amount of approximately $3.3 billion. Under optimistic assumptions, a long-term real GDP growth rate of 7 per cent seems feasible. In addition to the implementation of policies and reforms detailed in the SDRPR, a critical requirement for sustained poverty reduction and growth is internal and external peace. In particular, full resolution of the border demarcation problem between Eritrea and Ethiopia is crucial. Ethiopia has been identified as a potential candidate for Millennium Development Goal (MDG) fast-tracking, which, if it comes to pass, would give Ethiopia a considerable boost in terms of poverty reduction and growth[1].

Economic activity has strongly rebounded following last year's drought.

Figure 1 - Real GDP Growth



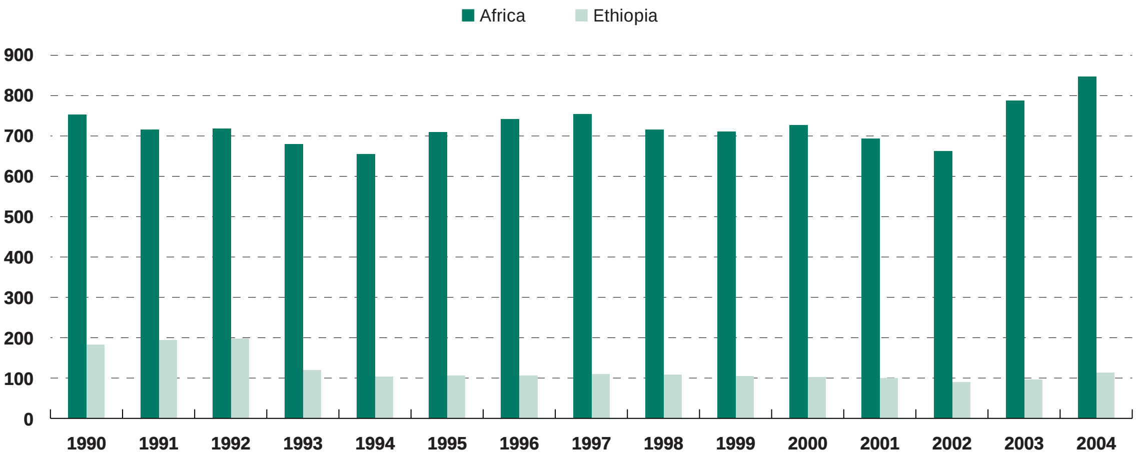
Source: IMF and domestic authorities' data; projections (p) based on authors' calculations.

Recent Economic Developments

After the severe drought of the last fiscal year, Ethiopia's real GDP recovered strongly, reaching an estimated growth rate of 11.5 per cent in 2003/04. The strong recovery, led by growth of almost 19 per cent in agricultural output, helped Ethiopia to continue with its economic reform and poverty reduction

1. See the Millennium Project's Report to the UN Secretary-General, Investing in Development – *A Practical Plan to Achieve the Millennium Development Goals*, January 2005.

Figure 2 - GDP Per Capita in Ethiopia and in Africa (current $)



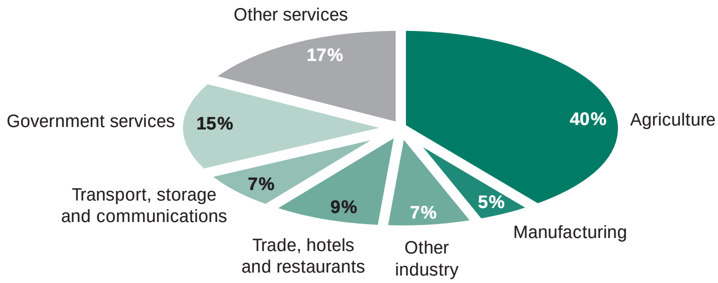
Source: IMF.

programme, with the ultimate goal of reaching the MDGs by 2015. Ethiopia is now targeting medium-term average real GDP growth of 7 per cent, the minimum growth rate necessary for achieving the MDGs. However, preliminary estimates for 2004/05 indicate a real GDP growth rate in the range of 5.6 to 6 per cent. Taking the latest international commodity prices into account and adopting relatively conservative assumptions about future aid flows to Ethiopia, our projections suggest a real GDP growth rate of 4.9 per cent for 2005/06 (see Figure 1). While the double-digit growth rate in agricultural production reflects a rebound from the drought-depressed level of 2002/03, it is encouraging that the recovery was not confined to agriculture. Non-agricultural sectors are estimated to have expanded at 6.8 per cent in 2003/04. At the same time, inflation has fallen to about 9 per cent (after a drought-affected 15.1 per cent in the previous fiscal year). Over the medium term, it is expected that the inflation rate will stabilise at about 5 per cent, reflecting prudent fiscal and monetary policies and assuming normal weather conditions.

The strong recovery of agricultural production in 2003/04 was largely due to favourable weather, resulting in a record growth rate of 19.2 per cent. This implied an increase in the GDP share of agriculture from 40 per cent in 2002/03 to about 45 per cent in 2003/04. The outlook for agricultural production continues to be positive, subject to weather conditions, though the growth rate will – due to the 2003/04 bumper harvest – moderate in 2004/05. Poverty-targeted government expenditures in agriculture have increased from 1.3 per cent of GDP (in 2002/03) to an estimated 1.5 per cent (in 2003/04), and are projected to increase to 1.9 per cent of GDP by the turn of the decade. Although until recently producer prices of coffee have fallen considerably, coffee remains the main agricultural export product.

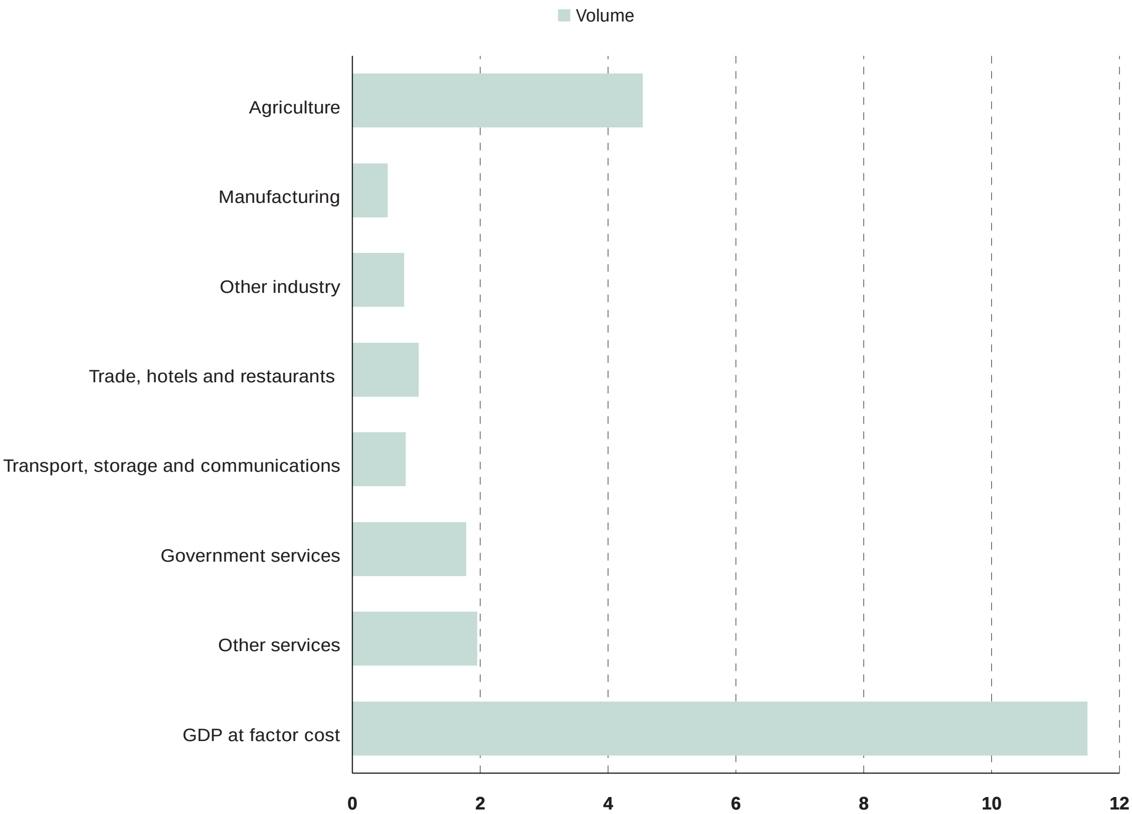
Ethiopia continues to face food insecurity and requires massive food aid, even under favourable weather conditions. Hence, in June 2003, a Coalition for Food Security was established between the government and its development partners, with the aim of attaining food security for 5 million people whose food supply is chronically insecure and of improving the overall food security of an additional 10 million people. Given the deteriorations in land security and increased land fragmentation due to increasing population pressures, the government is currently undertaking various reforms, concentrating on improvements in land tenure and land security, facilitation of voluntary resettlement from drought-prone to land-surplus areas and increased land productivity. Following proclamations on rural land aimed at improving land tenure and land security in four main regions of Ethiopia in 2002/03, rural land proclamations are currently under way in some of the other key emerging regions. It is anticipated that, due to these proclamations, the number of households with

Figure 3 - GDP By Sector in 2002/03 (percentage)



Source: Authors' estimates based on IMF and domestic authorities' data.

Figure 4 - Sectoral Contribution to GDP Growth in 2002/03 (percentage)



Source: Authors' estimates based on IMF and domestic authorities' data.

secure long-term land use rights will increase from fewer than 0.7 million in 2002 to over 8 million in 2005/06. Together with other initiatives to increase land productivity, it is anticipated that agricultural production will grow at an average of about 7 per cent over the medium term. Furthermore, Ethiopia's Environmental Protection Agency, established in 2002, is currently formulating policies and strategies to ensure the long-term environmental sustainability of agriculture and rural-based livelihoods in Ethiopia.

Given the strong recovery in agricultural production, the shares of industry and services in GDP were reduced to 10 per cent and 45 per cent respectively, even though real output in the two sectors grew at 6.1 per cent and 6.8 per cent respectively from 2002/03 to 2003/04. Within the industrial sector, manufacturing continues to be the dominant sub-sector, growing at 7 per cent in 2002/03 and an estimated 5 per cent in 2003/04. While the ability to generate hydro-electric power improved significantly due to favourable rains, the estimated 4 per cent growth in the overall electricity sector for 2003/04 is disappointing. Mining and quarrying activities continue to be a major source of growth in the industrial sector, growing at 9 per cent in 2002/03 and an estimated 8 per cent in 2003/04. As there was little demand for new construction following the severe droughts of 2002/03, construction was the slowest-growing industrial sub-sector, expanding by only 3.5 per cent in 2002/03. However, given that construction usually lags behind developments in the overall economy, the growth rate of the construction sector is estimated to have doubled in 2003/04. A positive impact on industrial growth is also expected from the industrial development strategy adopted in 2002, which recognises the role of the private sector as an engine for industrial development. It emphasises export-led industrialisation, the use of labour-intensive technologies and the need to encourage domestic and foreign joint ventures.

Growth in the services sector is dominated by sharp increases in the education and health sub-sectors, reflecting the priorities of the SDPRP. In 2003/04, the education and health sectors are estimated to have increased by 12 per cent and 8 per cent respectively. In 2003/04, transportation and communications are estimated to have grown by 8 per cent and 7 per cent respectively. Prospects for 2004/05 continue to be positive for the communications sector, although structural reforms in telecommunications are making only marginal progress. Growth prospects in the transportation sector are contingent on world oil prices and on the extent to which the state-owned Ethiopian Petroleum Enterprise passes on such price changes.

Gross domestic savings increased slightly from 1 per cent of GDP in 2002/03 to 1.3 per cent in 2003/04, though the savings rate still lags behind the 2001/02 rate of 2.5 per cent of GDP. A matter of concern is that the share of private savings in GDP decreased from an already low 0.6 per cent in 2002/03 to an estimated 0.3 per cent in 2003/04. Similarly, the share of private investment is estimated to have decreased from 10 per cent of GDP in 2002/03 to 9.6 per cent of GDP in 2003/04. These decreases in savings and investment shares reflect temporary increases in consumption during the recovery. It is anticipated that private savings and private investment will both pick up significantly in terms of GDP in the coming years. Total consumption is estimated to have increased sharply from 99 per cent of GDP in 2002/03 to 103.2 per cent of GDP in 2003/04, and is projected to grow more moderately over the medium term.

Table 1 - Demand Composition (percentage of GDP)

	1995/96	2000/01	2001/02	2002/03	2003/04	2004/05(p)	2005/06(p)
Gross capital formation	**16.9**	**17.8**	**20.4**	**20.5**	**19.5**	**20.3**	**20.5**
Public	7.5	8.5	11.5	10.5	9.9	10.1	10.3
Private	9.4	9.3	9.0	10.0	9.6	10.1	10.1
Consumption	**93.0**	**96.9**	**97.5**	**99.0**	**103.2**	**104.6**	**105.1**
Public	11.2	16.8	19.3	19.1	17.8	17.9	17.7
Private	81.8	80.1	78.2	79.9	85.4	86.7	87.4
External sector	**-9.9**	**-14.7**	**-17.9**	**-19.4**	**-22.7**	**-24.8**	**-25.6**
Exports	13.1	15.1	16.2	17.1	15.6	14.9	14.1
Imports	-23.0	-29.8	-34.1	-36.5	-38.2	-39.7	-39.7

Source: IMF and domestic authorities' data; projections (p) based on authors' calculations.

Macroeconomic Policies

Fiscal and Monetary Policy

After a temporary increase in the overall fiscal deficit (including grants) in fiscal years 2001/02 and 2002/03, estimates indicate that revenues continued to increase and expenditures were reduced in 2003/04, resulting in an overall fiscal deficit-to-GDP ratio of 5 per cent in 2003/04. While the overall deficit is expected to decrease further over the medium term, actual developments will depend critically on inflows of grants. Excluding grants, the overall fiscal deficit decreased from 16.4 per cent in 2002/03 to about 13 per cent in 2003/04 and is expected to remain around 12 per cent over the short term, due to the government's continued commitment to prudent fiscal policy. The government's anticipation of significant increases in grants is not likely to affect the overall budget deficit after grants, as these grants are expected to be used for poverty reduction expenditures.

Excluding expenditures on special programmes, which amount to about 1 per cent of GDP, recurrent expenditures decreased from a high of 23.7 per cent in 2002/03 to an estimated 22.4 per cent in 2003/04. This reduction in recurrent expenditures (relative to GPD) should be seen in the light of two factors:

Table 2 - Public Finances[a] (percentage of GDP)

	1995/96	2000/01	2001/02	2002/03	2003/04	2004/05(p)	2005/06(p)
Total revenue and grants[b]	**21.3**	**23.6**	**24.7**	**27.5**	**27.8**	**25.9**	**27.0**
Tax revenue	12.5	13.7	15.3	14.4	14.6	14.7	14.7
Oil revenue	2.9	4.8	4.7	8.0	8.1	6.0	7.2
Total expenditure and net lending[b]	**26.9**	**29.1**	**34.0**	**35.9**	**32.8**	**32.1**	**32.0**
Current expenditure	14.7	19.1	20.3	23.7	22.4	21.4	21.1
Excluding Interest	*12.3*	*17.2*	*18.4*	*21.6*	*20.2*	*20.2*	*19.9*
Wages and salaries	5.5	6.6	7.3	7.0	6.1	6.0	5.9
Interest	2.4	2.0	1.9	2.1	2.2	1.3	1.2
Capital expenditure	9.4	9.2	11.8	11.1	10.4	10.7	10.9
Primary balance	**-3.2**	**-3.5**	**-7.3**	**-6.3**	**-2.8**	**-5.0**	**-3.8**
Overall balance	**-5.6**	**-5.5**	**-9.3**	**-8.4**	**-5.0**	**-6.2**	**-5.0**

a. Fiscal year begins 1 July.
b. Only major items are reported.
Source: IMF and domestic authorities' data; projections (p) based on authors' calculations.

a) reductions in drought-related emergency expenditures; and *b)* higher than anticipated growth in GDP. Capital expenditure, which decreased during 2002/03 and probably also in 2003/04, is projected to increase considerably over the medium term (see Table 2). Relatively large investments in the education sector are a key factor underlying the projected increase in capital expenditure. There are some concerns about the possibility of higher defence expenditure, especially if the issue of the border demarcation between Eritrea and Ethiopia remains unresolved. Positive prospects for further improvements in Ethiopia's expenditure management are based on *a)* continuous progress in the consolidation of federal and regional budgets; and *b)* recent measures taken to improve the effectiveness, reporting and monitoring of local government expenditure. The level of defence spending in 2003/04 is estimated to have remained constant in nominal terms, and hence to have declined in real terms. Defence spending is projected to decline further in real terms once the border crisis with Eritrea is fully resolved.

Given the low taxation of agriculture, the strong recovery in agriculture entailed a decrease in the ratio of tax revenues to GDP, from 15.3 per cent in 2002/03 to 14.4 per cent in 2003/04. It is estimated, however, that in real terms, total revenues (excluding grants) increased by 7 per cent from 2002/03 to 2003/04, especially due to a sharp increase in import taxes. Revenues from income and profits taxes are estimated to have been significantly lower in fiscal year 2003/04, as earnings fell drastically during the drought. With the strong recovery of personal income and to a lesser extent profits, it is estimated that direct taxes will pick up over the medium term. The level of import taxes as a share of GDP is expected to decrease slightly in 2004/05, as imports return to their normal level. The medium-term outlook for tax revenues is good, based on continued reforms aiming at improving tax collection and enforcement.

Ethiopia's monetary policy continues to seek price stability by targeting monetary expansion to the growth rate of nominal GDP. After a drought-affected 15.1 per cent peak in Ethiopia's inflation rate in 2002/03, inflation fell to 9.6 per cent in 2003/04 and, influenced by favourable weather conditions, is expected to decrease further to 5.4 per cent in 2004/05. Following the contraction of the broad money supply relative to GDP in early 2004 (which was due mainly to a reduction of the government's net domestic debt to the banking system), Ethiopia's central bank is targeting a substantial increase in credit to both the government and the private sector. The central bank has also left its minimum interest rate on savings deposits at 3 per cent and its minimum lending rate at 7 per cent. Following the lead of the dominant Commercial Bank, the banking sector has also continued to adhere to these minimums.

External Position

Ethiopia's official exchange rate continues to be determined through weekly wholesale foreign exchange auctions, though the National Bank of Ethiopia (NBE) reserves its right to intervene through open market operations with the goal of keeping the birr relatively stable against the dollar (in which the majority of Ethiopia's import transactions are denominated). The difference between the official and parallel market exchange rates is narrowing and amounted to less than 1 per cent during 2003/04, partly due to enforcement of foreign exchange regulations, under which it is illegal to exchange foreign currency notes or travellers' cheques other than in designated foreign exchange bureaux. Due to the depreciation of the US dollar against most other major currencies, especially the euro, the birr depreciated in nominal terms, improving Ethiopia's competitiveness, particularly *vis-à-vis* Europe, its major export market. The real depreciation had some negative impacts on Ethiopia's efforts to reduce inflation, due to increased prices of imported goods not denominated in dollars.

The NBE increased its holdings of international reserves, due to strong export performance and higher than anticipated external assistance (of which a part came as delayed emergency assistance). Compared to 2002/03, gross international reserves remained stable during 2003/04, at the equivalent of slightly above four months of imports of goods and services, and stood at the equivalent of about five months of imports at end-June 2004. Hence, while oil price increases did not cause severe problems for Ethiopia's overall balance of payments during 2003/04, they imply a constraint on Ethiopia's capacity to import other important goods, especially if oil prices remain high.

Ethiopia's current account balance is estimated to have significantly improved during 2003/04, and was expected to improve further until recent increases in import prices (especially of oil and steel) dampened the positive outlook. Given that the import volume of petroleum products is considered to be highly inelastic (amounting to about 1.5 million metric tonnes a year during 2002/03 and 2003/04, and about 15 per cent of Ethiopia's total import bill), it is estimated that every 10 per cent increase in the price of oil will increase Ethiopia's import bill by about 1.5 per cent. Hence, while increases in oil prices alone do not seem to have severe effects on Ethiopia, prices of other key imports, especially steel, are closely correlated with oil prices. Hence, import price variations can have significant impact on Ethiopia's external balance. At the same time, there are reasonable expectations of considerable increases in aid flows to Ethiopia, which might counterbalance the increase in import prices. The trade deficit, estimated to have increased considerably from 2002/03 to 2003/04, is projected to reach about 24 per cent of GDP in 2004/05 and 2005/06, largely due to imports. Goods exports, dominated by coffee, pulses and oilseeds, are estimated to have grown considerably in real terms, but have remained relatively stable in terms of GDP from 2002/03 to 2003/04 (due to the estimated real GDP growth rate of 11.5 per cent for

2003/04). Goods exports are projected to increase slightly in terms of GDP share for 2004/05 and 2005/06.

While Ethiopia's merchandise exports continue to be dominated by agricultural products (about 75 per cent of the total), the share of non-traditional exports such as gold and leather products is growing. Furthermore, Addis Ababa continues to be a major city for international fora and conferences. Hence, Ethiopia seems to be making some progress in diversifying its exports, although high volatility of exports of individual products obscures the trend. In view of the fragile situation of many private and public enterprises, Ethiopia is currently not considering further trade liberalisation. The government justifies this on the grounds that it has already made significant progress in recent years in liberalising trade and will continue with its structural reform programme towards a market-based economy.

Ethiopia received inflows of foreign direct investment (FDI) equivalent to slightly more than 5 per cent of gross fixed capital formation in both 2002 and 2003. Over the medium term, Ethiopia expects to double the amount of FDI inflows to about $120 million a year (equivalent to about 1.5 per cent of GDP), especially after signing bilateral investment treaties with Belgium, Iran, Israel, Luxembourg, Mauritius, the Netherlands and Uganda in 2003.

In April 2004, Ethiopia reached the completion point under the enhanced HIPC initiative, which is estimated to reduce Ethiopia's external debt service by approximately $3.3 billion in nominal terms. Total assistance under the HIPC initiative is estimated to be equivalent to debt reduction in net present value (NPV) terms of $1.3 billion, agreed at the decision point, plus a topping-up of assistance in an amount equivalent to $700 million in NPV terms, approved at the completion point. The exceptional additional assistance under the

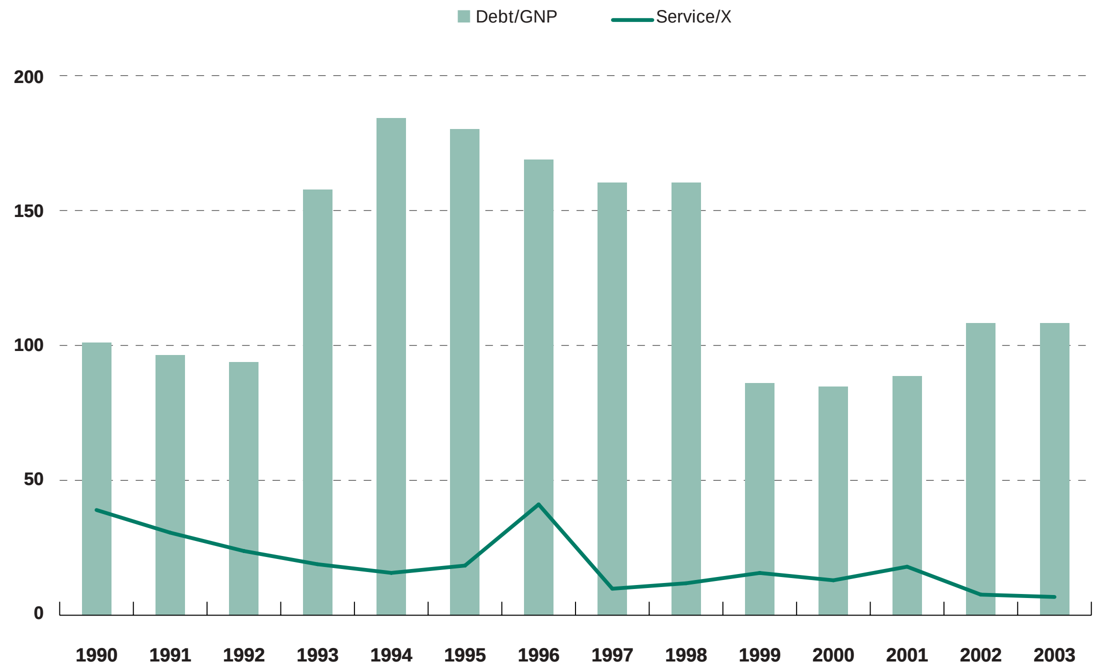
Table 3 - Current Account (percentage of GDP)

	1995/96	2000/01	2001/02	2002/03	2003/04	2004/05(p)	2005/06(p)
Trade balance	-12.2	-16.8	-20.4	-20.6	-23.2	-24.3	-24.2
Exports of goods (f.o.b.)	6.9	7.1	7.4	7.3	7.4	7.7	7.8
Imports of goods (f.o.b.)	-19.1	-23.9	-27.8	-27.9	-30.7	-32.1	-32.1
Services	2.2	2.1	2.5	2.9			
Factor income	-0.7	-0.9	-0.7	-0.8			
Current transfers	11.0	11.7	12.9	15.9			
Current account balance	**0.3**	**-3.9**	**-5.7**	**-2.7**			

Source: IMF and domestic authorities' data; projections (p) based on authors' calculations.

topping-up framework has been granted to Ethiopia due to exogenous shocks that adversely affected its debt sustainability, raising the NPV of its debt-to-exports ratio at end-2002/03 substantially above the 150 per cent threshold established under the enhanced HIPC framework. Ethiopia is close to reaching bilateral agreements on HIPC debt relief with the United Kingdom and the United States. Negotiations are progressing well with other Paris Club creditors and have been initiated with most other bilateral and commercial creditors. Resources made available by debt relief under the HIPC initiative are being allocated to pro-poor expenditure programmes. In 2001/02 and 2002/03, poverty-targeted spending has increased by $259 million (3.3 per cent of GDP), substantially more than HIPC relief, reflecting the resumption of donor assistance and a reduction in military spending. The stock of domestic debt rose from 37.4 per cent of GDP in 2000/01 to 39.1 per cent of GDP in 2002/03, and is projected to increase to 41 per cent of GDP in 2003/04. Together with the World Bank and Debt Relief International (DRI), the government is currently preparing a strategy for reducing both external and domestic debt. Furthermore, in order to increase the effectiveness of aid, Ethiopia's donors are harmonising their assistance, using Ethiopia's SDPRP and shifting from project to budgetary assistance. It has also been recognised that per capita aid flows to Ethiopia of $13 per person are less than half the average for sub-Saharan Africa.

Figure 5 - Stock of Total External Debt (percentage of GNP) and Debt Service (percentage of exports)



Source: World Bank.

Structural Issues

Although they stagnated somewhat during the border conflict with Eritrea, various legal and regulatory reforms have been initiated since December 2000, particularly involving agriculture and public services. Though actual progress remains slow in some areas, especially with regard to securing private land ownership, the revision of the investment code yielded benefits such as an increase in the number of bilateral investment treaties signed[2]. Progress has also been made in resolving some of the key bottlenecks that emerged following fiscal decentralisation. The ability to track poverty-reducing spending in the *woradas* (districts) has improved, the period for fiscal reporting from the *woradas* to the central government has been shortened and the fiscal discipline of the *woradas* has been strengthened. Based on Ethiopia's agriculture-led industrialisation strategy, a new extension system known as the Participatory Demonstration and Extension Training System (PADETS) has been put in place.

Considerable progress has been made in Ethiopia's financial sector. Ethiopia's financial system consists of commercial banks, micro-finance institutions (MFIs) and financial co-operatives. The commercial banks include three state-owned banks: the Commercial Bank of Ethiopia (CBE), the Construction and Business Bank (CBB) and the Development Bank of Ethiopia (DBE), as well as six private banks. While some private banks have up to about 30 branches, the CBE, with 72 branches, has a market share of about 70 per cent. Unlike public banks, which exclusively serve large enterprises, some private banks are also active in financing small and medium-sized enterprises. All three public banks are supposed to be restructured and/or privatised. While the restructuring of the CBE is moving forward according to plan, there have been numerous

2. Since 1994, investment licences have been issued to 8 000 investment projects with a combined capital of about $10 billion; of this total, 3 421 investment projects with an aggregate capital of about $5 billion have become operational.

delays with the privatisation of the CBB. The DBE has been re-capitalised five times, most recently in 2003. The 2003 re-capitalisation went hand-in-hand with a major restructuring, but further restructuring is needed in order to maintain the bank's long-term viability. Foreign banks have so far not been allowed to enter Ethiopia on the grounds that financial reform must come first. One major regulatory change in the banking sector, which came into effect in March 2004, allows Ethiopians residing outside Ethiopia, as well as foreigners of Ethiopian origin, to open Ethiopian bank accounts in foreign currency.

The government as well as Ethiopia's donors have recognised the importance of micro and small-enterprise (MSE) development, and several federal and regional MSE development agencies have been established. Various donors (including the African Development Bank, the European Union, Germany, the Netherlands, the United Nations Industrial Development Organisation – UNIDO, and the World Bank) are supporting the development of MSEs through the provision of a variety of business support services. The latest approach is to link MSEs to medium-sized and large enterprises in order to develop value chains. The number of MSEs nearly doubled from 1997 to 2003, with the increase being attributed to the improvement in the support provided by the government, donors, NGOs and private sector initiatives. As of 2003, it was estimated that there were about 1.2 million micro-enterprises and about 65 000 small enterprises active in Ethiopia. Of these MSEs, 47 per cent were active in manufacturing, 42 per cent in services and trade, 6 per cent in community and personal services, and 5 per cent in agriculture, construction and transportation[3]. Though MSEs account for 99 per cent of business establishments and about 90 per cent of total employment in the manufacturing sector, their share of manufacturing output is only about 50 per cent. In addition to a lack in entrepreneurship, which is partly due to traditional values and norms, the lack of sufficient financing for MSEs is considered to be the most severe constraint on MSE development. The main source of capital for MSEs is personal savings or gifts/borrowing

Micro-finance Regulations: Small Changes Can Have Large Impacts

Recognising the importance of financial services to stimulate productivity and economic self-reliance, the government, NGOs and donors took the initiative to introduce innovative micro-financial services in the late 1980s. The government subsequently issued a proclamation and other regulatory directives for licensing and supervision of MFIs. In June 1999, the Association of Ethiopian Microfinance Institutions (AEMFI) was established to provide training, research, performance monitoring and advocacy for its members. Due to the efforts and services provided by the AEMFI, micro-finance institutions became increasingly successful in providing micro-finance to the rural poor, but there remained a considerable gap in financing MSEs. Based on the advocacy of the AEMFI, private sector agencies and donors engaged in Ethiopia's private sector development, the government enacted in 2003 a variety of regulatory changes that made it easier for MFIs to finance MSEs, mainly by increasing the maximum loan amount and extending the maximum loan maturity. As of mid-2004, there were 23 MFIs, which – following the regulatory changes – had extended their customer base from financing exclusively poor individuals to the financing of MSEs. While preliminary, the experience thus far suggests that the financing of MSEs has not only contributed significantly to the development of MSEs, but has also made MFIs more profitable and thus more sustainable. It is anticipated that some of the current MFIs will develop into full-fledged rural banks in a couple of years, which will then also be able to finance medium-sized enterprises.

3. Data based on various surveys undertaken by the Central Statistical Authority (CSA) in 1997 and 2003, as well as data provided and collected during interviews with the Association of Ethiopian Microfinance Institutions, representatives of the Ethio-German Micro and Small Enterprise Development Programme, and the Ethiopian Chamber of Commerce in October 2004.

from relatives and friends. Nevertheless, considerable progress has been made during the last two years in the provision of financing for MSEs through micro-finance institutions (MFIs), thanks to regulatory changes enacted in 2003 (see box on previous page).

In 1994, the government had embarked on a privatisation programme and created the Ethiopian Privatisation Agency (EPA), but progress has slowed during the last few years. While 178 mostly small public enterprises were privatised by 1998, only 22 more were sold to the private sector by April 2002, and eight more by June 2004. Hence, of the 313 enterprises originally scheduled to be privatised by the end of fiscal year 2003/04, 105 remain in government hands, including most of the large enterprises. In 2003, the EPA commissioned a study (financed by the German co-operation agency GTZ) to identify the reasons for the slow progress of Ethiopia's privatisation programme. Non-negotiable prices, inadequacy of valuation skills and the requirement that the buyer retain the entire workforce were considered to be the key impediments. Furthermore, it became clear that co-ordination problems between the EPA and the Public Enterprise Supervisory Authority (PESA) impeded transactions, especially after the PESA had been given a new mandate in 2002 to negotiate joint ventures, management contracts and the leasing of public enterprises. Based on the GTZ-financed study and subsequent reviews, concrete suggestions have been made for an integrated programme for all institutions involved. The government is in the process of finalising a detailed action plan.

While infrastructure facilities such as roads, electricity, water and communication media are relatively well developed in Addis Ababa, the picture changes considerably in some of the rural areas. Hence, there is a highly uneven distribution in the provision of infrastructure facilities across Ethiopia. Overall, Ethiopia has only 15 per cent of its national road network paved and only about 5 per cent of the population has access to electricity. Owing to lack of resources and other priorities, however, there were no major changes in the provision of infrastructure during 2003/04. The government continues to control the energy and telecommunications sectors.

Ethiopia has also made significant progress in easing regulatory burdens. Based on a 2004 World Bank report[4] assessing the business climate around the globe, Ethiopia is among the top performers in sub-Saharan Africa (SSA). According to the evaluation criteria, it takes fewer procedures and fewer days to start a business in Ethiopia than in the average country of SSA. It also takes slightly fewer procedures and slightly fewer days to enforce contracts. The costs of starting a business and of enforcing contracts are also below those of the average SSA country. Ethiopia also fares better than the average SSA country in all five indicators that measure how difficult it is to hire and fire workers. Although about twice as many procedures are required to register a property in Ethiopia, it takes only 56 days (compared to the SSA average of 114 days) to register a property in Ethiopia. Other obstacles remain, however, including poor roads, low demand, low skill levels and limited access to credit.

Political and Social Context

Following the peace agreement signed in December 2000, Ethiopia has made significant progress in maintaining peace with Eritrea. After a withdrawal and demobilisation of the two countries' troops following the peace agreement and the independent Boundary Commission's judgement on the location of the border in April 2002, the physical demarcation of the border took place in May 2003. There is some opposition to the government's conciliatory attitude towards Eritrea, however, and the formal agreement on the border demarcation has yet to be ratified. In November 2004, Ethiopia presented to the international community a five-point plan to resolve the border crisis. Under the plan, Ethiopia agreed to implement the ruling of the Border Commission and to co-operate in the demarcation of the border.

4. *Doing Business in 2004: Understanding Regulation*; available on the World Bank website.

Democratisation has advanced, including decentralisation of authority from the regional to the *woreda* (district) level. The government is also implementing the various components of judicial reform as specified in the SDPRP of 2002. Based on a comparison of the Transparency International's Corruption Perceptions Indices for 2003 and 2004, Ethiopia seems to have made no progress in reducing corruption. While the October 2004 report by Transparency International ranked Ethiopia 114th out of 146 countries[5], Ethiopia fares slightly better in the perception of corruption than other countries with similar levels of GDP per capita.

The UNDP 2004 has ranked Ethiopia 137th out of 144 countries in terms of the status, treatment and participation of women (as measured by the UNDP's gender-related development index – GDI). Compared to its ranking on the overall human development index (HDI), viz. 170th out of 177 countries, Ethiopia ranks marginally better on the GDI. Yet, as a USAID report of March 2004 points out, Ethiopian women are socially subordinated, cultural and religious customs support male over female rights, and sexual violence is widely accepted. The report also notes that gender roles are a major constraint in combating the spread of HIV/AIDS, as well as making progress in other areas, notably education, women's economic empowerment and women's political participation. With 7.8 per cent of seats in parliament held by women, Ethiopia ranks 127th (out of 163 countries) on this score. The proportion of females in total population fell from 50.4 per cent in 1990 to 49.8 per cent in 2003. While life expectancy decreased by about two years for both men and women over the last five years (due to HIV/AIDS), Ethiopian women live about two years longer than Ethiopian men.

With one of the lowest levels of GDP per capita in the world, amounting to $96 in 2003, poverty and even the threat of starvation remain high in Ethiopia, especially in rural areas. Though there are signs of improvement, the relatively high level of adult HIV/AIDS prevalence remains a heavy burden. While this level has decreased by one third (from 6.6 per cent in 2001 to 4.4 per cent in 2003), it is estimated that the percentage of orphans due to HIV/AIDS in total orphans will increase from the current 25.8 per cent to about 43 per cent in 2010, at which time the number of total orphans is projected to exceed 5 million.

Despite the recent drought, the government is making good progress in implementing the 2002 SDPRP, the overriding objective of which is to reduce poverty while maintaining macroeconomic stability. Ethiopia remains heavily dependent on external assistance, which will need to be increased significantly in order to reach the MDGs. In order to maintain Ethiopia's public debt sustainability, the increase in external assistance will need to be provided mostly in the form of grants.

Some progress has been registered in health and education. The Ethiopian government's second Health Sector Development Programme (HSDP) was reviewed in 2003 and the government is moving ahead on several significant fronts, which include: implementing health sector reform; improving health management systems; implementation of health extension packages (HEP) to expand services to all rural communities; strengthening health products logistics systems; and combating malaria, tuberculosis and HIV/AIDS more actively. The government is currently also revising its population policy, emphasising immediate and sustained implementation of family planning programmes. In October 2004, the Disaster Prevention and Preparedness Commission launched a new programme that aims at providing some 5 million beneficiaries with a safety net. The programme, which is part of Ethiopia's five-year "New Coalition for Food and Livelihood Security", was scheduled to begin in early 2005. The project implementation manual has been prepared and will guide the implementation of the programme in selected drought-affected areas of Ethiopia. The five-year programme carries a $3 billion price tag, and will involve multi-annual food aid and cash commitments

5. Rank 114 is shared with the Republic of Congo, Honduras, Moldova, Sierra Leone, Uzbekistan, Venezuela and Zimbabwe.

as well as strategies aimed at reversing food aid dependency, a safety net programme with the provision of food or cash tied to beneficiary participation in public works and the improvement of agricultural technology in drought-prone areas.

Education, particularly primary education, has been identified as a national priority and increased expenditure earmarked for primary education. Ethiopia is in the midst of its second Education Sector Development Programme (ESDP) with the goal of achieving universal primary education by 2015. The education strategy emphasises decentralisation, community participation, cost sharing mechanisms (at secondary and tertiary levels) and the involvement of the private sector. In March 2003, the government launched a School Net and Woreda Net Initiative with the objective of improving the quality of and access to secondary and higher education. The Initiative also aims at improving communication and co-ordination among different levels of government involved in the education sector.