Ethiopia

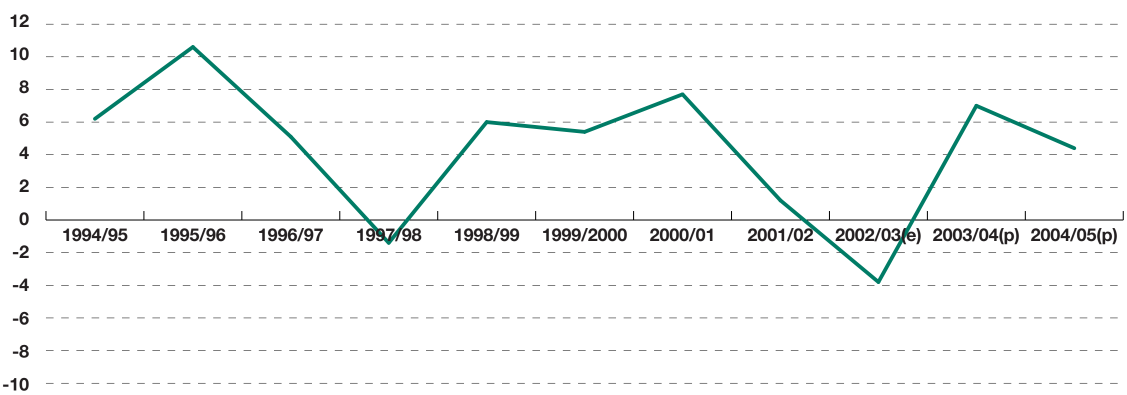
key figures

• Land area, thousands of km^2	1 104
• Population, thousands (2002)	68 961
• GDP per capita, $ (2001/2002)	88
• Life expectancy (2000-2005)	45.5
• Illiteracy rate (2002)	58.5

ETHIOPIA'S DIFFICULT FOOD SITUATION was aggravated by drought in 2002/03, described as the worst since 1998/99. As a result, real GDP growth was recorded at –3.8 per cent in 2002/03, compounding the pervasive poverty in the country. In 2002/03, about 12.6 million Ethiopians needed food assistance to survive, compared with about 5 million people needing food aid in a normal year. Although real GDP is estimated to rise by 7 per cent in 2003/04, the food situation will remain precarious, with an estimated 7 million people still requiring food assistance. Real GDP growth should remain positive at a projected 4.4 per cent in 2004/05. In spite of the difficult environment, the government has maintained prudent economic policies, and, with strong donor support, has continued to increase spending on poverty-related activities. However, the stability of economic fundamentals will continue to depend heavily on international support. The government has maintained structural reform efforts and continues to implement measures to strengthen the economy. Nonetheless, several drawbacks to an efficient and competitive private sector remain. In the energy sector, Ethiopia has both short and long-term plans to develop energy management, and increase general access to modern forms of energy, which is currently very low. Relations with its neighbours have improved markedly since the end of its border conflict with Eritrea. However, democracy in the country is struggling amid widespread accusations by opposition groups of government intimidation. Furthermore, the federal unity is challenged by considerable rebel activity. These situations require the government to tackle fundamental problems in a bid for sustained peace, which is needed to confront pervasive poverty, support a health system unable to cope with the growing needs of the population, and reform an educational system still offering one of the lowest enrolment and literacy levels in sub-Saharan Africa.

Real GDP is estimated to rise by 7 per cent in 2003/04, but the food situation will remain precarious.

Figure 1 - **Real GDP Growth**

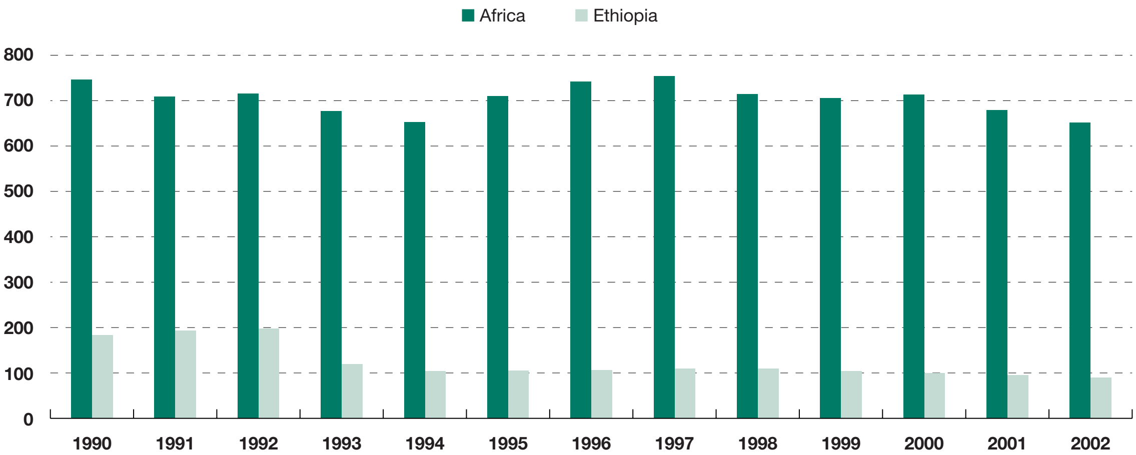


Source: IMF and domestic authorities' data; projections based on authors' calculations.

Recent Economic Developments

Ethiopia is pursuing an economic programme designed in the context of a medium-term framework for 2001/02-2003/04. The objective of the programme was to achieve an annual real GDP growth of 6 per cent. However, the country's economic performance in the last two years has been affected by severe drought. In 2002/03, real GDP growth was -3.8 per cent following the low growth of 1.2 per cent achieved the preceding

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

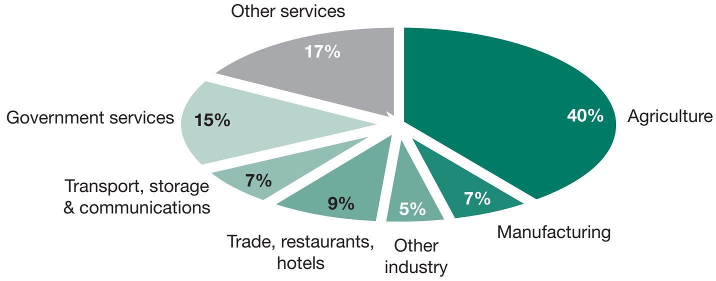


Source: IMF.

year. Economic activity is expected to resurge in 2003/04 however, when real GDP growth is estimated to reach 7 per cent. This estimation assumes improved weather conditions and the resumption of normal agricultural activity. Economic growth is projected to moderate to 4.4 per cent in 2004/05.

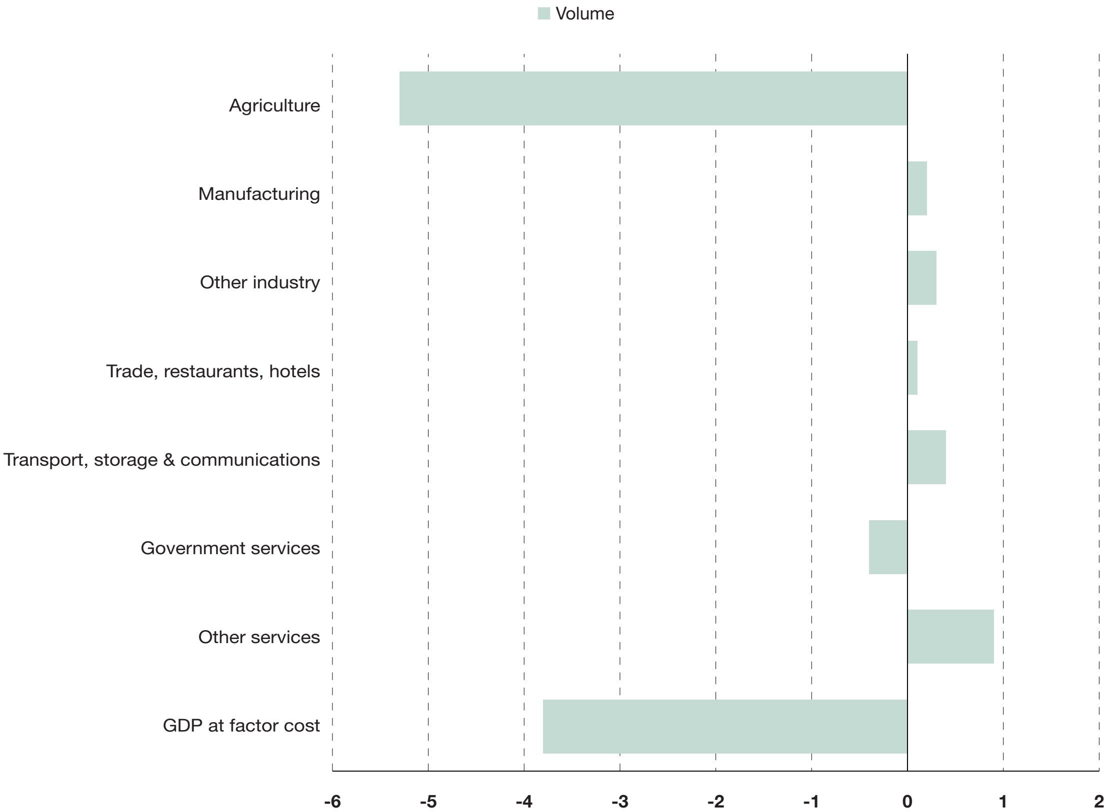
In sharp contrast to the bumper harvest achieved in 2000/01 and the relatively strong growth of 4.5 per cent the following year, agricultural production in 2002/03 was severely affected by drought. Consequently, agricultural output declined by 12 per cent in 2002/03, compared with the annual average growth rate of 2.5 per cent during 1991/92-2001/02. Indeed, the share of agriculture in total GDP shrank to nearly 40 per cent in 2002/03 from 43 per cent the previous year. The normal two rainy seasons failed in about 80 per cent of the country during 2002/03. As a result, grain production in particular was severely affected. The production of cereals, pulses and other food crops in 2002/03 was estimated at 7.6 million tons, which was 25 per cent below the 2001/02 harvest and 21 per cent below the five-year annual average. Similarly, due to the drought, livestock production fell by 6 per cent, while coffee output also fell by 8 per cent in 2002/03. The drought and the resulting severe decline in the cereal harvest left an estimated 12.6 million (about 20 per cent of the population) Ethiopians in need of food assistance in 2002/03, compared with about 5 million people in a normal crop year. In response to this dire situation, the government is implementing both short and long-term agricultural measures to ensure food security. In the short term, the government has increased budgetary allocations for food purchases and water harvesting schemes. In 2003/04, about 1.2 billion *birr* (ETB) ($140 million, 1.8 per cent of GDP) has been allocated to purchase local food (100 000 tons) and for water harvesting. In the water harvesting schemes, about 200 000 households are expected to benefit from water catchment and storage facilities supplied by the government. In the medium term, the government plans to develop irrigation schemes and to continue its resettlement programme. In addition, the government is taking steps to improve the competitiveness and efficiency of the fertiliser market, including provisions for flexible access to foreign exchange for fertiliser imports, withdrawal of the agricultural extension service from input distribution and input credit management, strengthening of farmers' co-operatives to replace regional governments in administering fertiliser credit, and a reduction in the up-front financing requirements for importing fertiliser. Nonetheless, the effect of the drought in 2002/03 continues to loom large on agricultural output in 2003/04. Available information suggests that while agricultural performance may improve in 2003/04, the improvement will not be sufficient to avert a continuing food crisis. Estimates for agricultural production in 2003/04 put the output of cereals, pulses and other crops at 8.7 million tons,

Figure 3 - **GDP By Sector in 2002/03**



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

Figure 4 - **Sectoral Contributions to Real GDP Growth, 2002/03**



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

which is 17 per cent higher than in 2002/03 but 1.1 per cent lower than the average over the last seven years. The estimate of food-crop production translates into food deficits of about 2.2 million tons for 2003/04, less than those experienced in 2002/03 (3.4 million tons), but similar to the deficits experienced in 1997/98. Thus, the overall humanitarian needs for 2003/04 are reduced significantly when compared with 2002/03. According to the World Food Programme (WFP) however, about 980 000 tons of food aid will still be needed in 2004 to feed the nearly 7 million people still requiring food aid.

While the agricultural sector was directly affected by the drought in 2002/03, the resulting water shortage significantly impacted on other sectors as well. For most of 2002/03, Ethiopia's ability to generate hydroelectricity was drastically affected, causing electric power rationing throughout the country. Also, the poor performance of agriculture affected the agro-processing industry. The industrial sector's share of GDP rose from about 10 per cent in 2001/02 to about 12 per cent in 2002/03 due to the large contraction in agriculture, even though the industrial growth rate fell from 5.8 per cent in 2001/02 to 4.9 per cent in 2002/03. A rise in mining and quarrying outputs was the sole source of growth in industrial output in 2002/03, as manufacturing, electricity and construction activities all slowed down compared to their performances in the preceding year and electricity output declined. In manufacturing, the reduction in electricity due to the drought took the biggest toll on small industries, where the growth rate in 2002/03 at 0.5 per cent was less than half the rate in the preceding year. Large and medium-scale manufacturing enterprises, which contribute about 88 per cent of manufacturing value-added, maintained a growth rate of 5 per cent in 2002/03 backed by their ability to obtain power from their own generators.

The service sector remained dominant in total GDP with its share increasing to 48 per cent in 2002/03 from 45.8 per cent in 2001/02. Growth in the services sector was slower however at 2.3 per cent in 2002/03 compared with 4.5 per cent in 2001/02. In 2002/03, the distributive services (trade, hotels and restaurants, transport and communication) accounted for about 16 per cent of GDP, while other services contributed about 32 per cent. The main engines of growth in the services sector during 2002/03 were transportation, communication and social services (education and health). The government has continued to divert resources from defence expenditure to social services since the end of the border conflict with Eritrea. Education services expanded by 10.1 per cent in 2002/03, while health services rose by about 8 per cent.

Table 1 - **Demand Composition** (percentage of GDP)

	1995/96	1999 /2000	2000/01	2001/02	2002/03(e)	2003/04(p)	2004/05(p)
Gross capital formation	**16.9**	**15.9**	**17.8**	**20.5**	**22.2**	**22.1**	**22.4**
Public	7.5	5.2	8.5	9.2	11.5	11.7	12.1
Private	9.4	10.7	9.3	11.3	10.7	10.4	10.4
Consumption	**93.0**	**99.1**	**97.4**	**98.2**	**102.1**	**103.4**	**103.2**
Public	11.2	23.8	20.1	22.4	22.6	21.9	21.7
Private	81.8	75.3	77.3	75.8	79.5	81.5	81.5
External sector	**-9.9**	**-14.9**	**-15.1**	**-18.7**	**-24.3**	**-25.5**	**-25.7**
Exports	13.1	15.1	14.7	15.5	15.2	15.3	15.1
Imports	-23.0	-30.0	-29.9	-34.2	-39.5	-40.8	-40.8

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

The expenditure composition of GDP shows a significant rise in total consumption in GDP in 2002/03 resulting from a rise in both public and private consumption. The rise in public consumption reflected the government's increased activities in the social sector. The rise in consumption was enabled by the significant rise in imports supported by massive foreign assistance during the year. The GDP demand composition structure is expected to be maintained into 2004/05. The downside of this structure, which shows that structurally domestic saving is close to zero, is that Ethiopia's heavy dependence on foreign aid will continue into the foreseeable future.

Macroeconomic Policy

Fiscal and Monetary Policy

Ethiopia's current fiscal policy objective is to achieve public debt sustainability and maximise the efficient use of highly concessional resources for poverty-reduction related activities. Within the government's medium-term economic programme, fiscal policy stresses two main objectives: *(i)* the re-orientation of budgetary resources away from defence toward poverty alleviation outlays; and *(ii)* tax reforms aimed at improving revenue performance. However, the government's recent fiscal activities, to a large extent, continue to highlight the significance of donor support. In 2002/03, the overall fiscal deficit increased to 8.3 per cent of GDP from 7.3 per cent the year before. However, excluding grants, the deficit was estimated to have widened from 12 per cent of GDP in 2001/02 to 16.3 per cent of GDP in 2002/03, reflecting emergency assistance grants equivalent to about 5 per cent of GDP and highlighting the significant impact of donor grants on the budget. The government's fiscal activities should help to stabilise the overall fiscal deficit in 2003/04 and 2004/05, albeit at a higher level than in 2002/03. The overall fiscal deficit is estimated to rise to 9.7 per cent of GDP in 2003/04 following a significant reduction in grants as the food crisis subsides relative to 2002/03. The overall deficit is projected at 9.4 per cent of GDP in 2004/05.

In spite of the difficult macroeconomic situation of the past two years, the government has continued with efforts to enhance domestic revenue mobilisation and pursue prudent public expenditure management. Several tax measures were implemented in 2002/03 to promote revenue mobilisation, including the introduction of VAT. Efforts were also made to improve tax administration and collection, including the strengthening of the large taxpayer unit, which accounted for about 75 per cent of total tax revenues, and to enhance the activities of the tax reform taskforce. As a result, total tax revenue rose to the equivalent of about 15 per cent of GDP in 2002/03. Tax revenue is estimated to be maintained at this rate in 2003/04 and 2004/05. This stability will be backed by the full-year implementation of VAT in 2003/04, as well as the ongoing implementation of tax reform measures. In addition, measures are being pursued to collect tax arrears, such as empowering enforcement and special units to deal with arrears, which are expected to be enhanced by the computerisation of tax identification numbers (TIN).

On the expenditure side, the emergency situation over the last two years placed considerable strain on expenditure management. Nonetheless, prudence in expenditure management and increased inflows are enabling the government to increase poverty-reduction spending on social services, especially education and health, and in other areas including roads and agriculture. In 2002/03, real expenditure on road improvements increased by nearly 40 per cent, while that on agriculture rose by about 33 per cent. In particular, the government has maintained a reduced rate of increase in defence expenditures since the end of its war with Eritrea. Defence expenditure growth was –2.7 per cent in 2002/03, the lowest rate of growth for over a decade. Total government expenditure (including special programmes) increased

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

	1995/96	1999/2000	2000/01	2001/02	2002/03(e)	2003/04(p)	2004/05(p)
Total revenue and grants[b]	**21.3**	**21.2**	**24.4**	**24.9**	**28.8**	**27.4**	**27.6**
Tax revenue	12.5	11.5	13.7	15.3	15.2	15.2	15.2
Grants	2.9	2.9	4.8	4.7	8.3	6.9	7.0
Total expenditure and net lending[b]	**26.9**	**30.8**	**27.9**	**35.0**	**37.5**	**37.2**	**37.0**
Current expenditure	14.7	23.6	17.4	21.3	24.8	24.3	24.2
Excluding interest	*12.3*	*21.3*	*15.4*	*19.4*	*22.5*	*22.0*	*21.9*
Wages and salaries	5.5	6.6	6.6	8.0	7.3	6.9	6.8
Interest on public debt	2.4	2.3	2.0	1.9	2.2	2.3	2.4
Capital expenditure	9.4	7.2	9.8	11.9	11.6	11.8	12.1
Primary balance	**-3.2**	**-7.3**	**-1.5**	**-8.2**	**-6.5**	**-7.4**	**-7.0**
Overall balance	**-5.6**	**-9.6**	**-3.5**	**-10.1**	**-8.7**	**-9.7**	**-9.4**

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

to 37.5 per cent of GDP in 2002/03 from 35 per cent of GDP the year before. This increase largely reflected the high level of food aid received. Inflows, which were higher than expected due to grants, enabled the government to adopt a supplementary budget for 2002/03 in May 2003, increasing government spending by about 1.1 per cent of GDP.

In 2003/04, the government emphasised its determination to maintain prudence in expenditure management. To that effect, measures include a comprehensive public expenditure management and fiscal decentralisation programme. Since this programme began in 2002, significant headway has been made. In 2002/03 the government decentralised fiscal powers to the *woradas* (districts) of the four largest regions. However, the implementation of the *worada*-decentralisation process has further strained the public expenditure management system and its ability to track poverty-reduction spending. In particular, fiscal reporting, which was already subject to considerable delay, has lagged further behind in some regions, endangering efforts to report on consolidated budget out turns. Also, the additional administrative requirements and staffing needs of the new system have put further pressures on the system, as the *woradas* have found it difficult to attract suitably qualified individuals. These difficulties place additional responsibilities on the government to guide the regions in implementing the decentralisation process. The government is committed to ensuring adequate fiscal reporting from the *woradas* to strengthen the budget management programme. Other measures being pursued in 2003/04 to enhance fiscal discipline include the consolidation of federal and regional budgets. Also, measures have been put in place to improve the effectiveness, reporting and monitoring of local government expenditure. The successful implementation of these measures will enable the government to maintain stability in its total expenditure at the estimated level of 37.2 per cent of GDP in 2003/04 and at 37 per cent of GDP the following year.

Monetary policy is focused on achieving stability in domestic prices and increasing external reserves. In 2002/03, attention was focused on sterilising excess liquidity and moving towards allowing greater market determination of the exchange rate of the *birr* (ETB). A tighter monetary policy stance reduced the growth of broad money supply (M2) to 11.3 per cent from 12.3 per cent in the preceding year. Reflecting the weak economic activity in 2002/03 and the decision of the Commercial Bank of Ethiopia (CBE), the leading bank in the country, to stop lending to all institutions with non-performing loans, total credit to the private sector increased by only 4.8 per cent in 2002/03, compared with 7.1 per cent in 2001/02. Increased credit to the government was maintained at 3.1 per cent in 2002/03.

The foreign exchange rate of the *birr* is now market-determined, with an inter-bank foreign exchange market in operation. Similarly, all interest rates are market-determined, with the exception of the savings deposit rate set at 3 per cent. The nominal value of the *birr* depreciated marginally in 2002/03 against the US dollar to reach ETB 8.6 per one US dollar at end-April 2003. Ethiopia experienced a fall in consumer prices in 2001 and 2002 as a result of improved agricultural production in these years coupled with the availability of food aid. However, inflation reappeared in 2002/03, rising to 14.6 per cent, from –7.2 per cent in 2001/02, mainly because of food shortages. Inflation is expected to moderate, with the rate of inflation estimated to fall to about 4.2 per cent in 2003/04, and down to an historically low level of 2.3 per cent in 2004/05.

External Position

Ethiopia continues to make progress towards liberalising its external trade to enhance its participation in the global economy, which remains very low, even by sub-Saharan African standards. The government's ongoing trade liberalisation policies are set within the framework of COMESA. Following the government's own study on effective protection in 2002, the average import tariff was reduced from 19.5 per cent to 17.5 per cent in 2003. At the same time, the number of tariff bands was also reduced from 7 to 6. The government is committed to addressing a number of identified restrictions that continue to hamper free trade. These restrictions include: *a)* the tax certification requirement for repatriation of investment income; *b)* restrictions on repayments of legally-contracted external loans and supplies, and foreign partners' credits; *c)* rules for the issue of import permits; and *d)* the requirement to provide a clearance certificate from the National Bank of Ethiopia (NBE) to obtain import permits.

The external payments situation has remained stable, primarily due to donor inflows. The current account deficit was about 6 per cent of GDP in 2002/03. The impact of donor inflows on the current account is demonstrated by the fact that in 2002/03, without such inflows, the deficit would have been about 15.2 per cent of GDP. The outlook on the external payments situation is that Ethiopia will only be able to maintain stability in its current account with substantial donor support, as the trade deficit is expected to widen significantly in 2003/04 and 2004/05.

The merchandise export sector is dominated by agricultural products, with coffee, qat, oilseed, pulses and horticultural products being the most important. The total value of merchandise exports increased to $468 million (7.4 percent of GDP) in 2002/03, from $431 million (7.1 percent of GDP) in 2001/02. The value of coffee exports declined in 2002/03 to $142 million from $158 million in the preceding year. The decline was due to falls in both volume and price. The decline was offset however, by robust growth in other merchandise exports, including gold, qat and leather. The service export sector, which is comparable in size to the merchandise exports sector, is principally based on transportation and related activities. It has grown steadily over the past decade, as Addis Ababa has become a regional capital for international organisations, conferences, and an airline transportation hub. Total imports of goods increased to 31.1 per cent of GDP in 2002/03 from 28.1 per cent of GDP in 2001/02 as a result of large-scale food imports and higher oil prices.

The total external debt stood at $5.9 billion at the end of 2002, shared between multilateral creditors (51 per cent); official bilateral creditors (46 per cent, of which 30 per cent to Paris Club creditors); and commercial creditors (2 per cent). Ethiopia reached the decision point for debt relief under the enhanced HIPC initiative in November 2001. Earlier in March 2001, Ethiopia had received supplementary debt relief commitments from the Paris Club of official donors. Bilateral agreements were concluded with its Paris Club creditors following meetings in April 2002. The annual savings of Ethiopia's debt relief under the enhanced HIPC arrangements will average about $96 million per year over the next three decades. This relief halved the debt service ratio of the country to about 7 per cent in 2003, from about 16 per cent in 2001; the debt service ratio is expected to fall below 4 per cent by the end of 2021. However, the point of completion, which was scheduled to be reached by the end of 2003, is now expected sometime in 2004, as Ethiopia needs more time to meet various targets. The government is concerned with the sustainability of its external debt under the enhanced HIPC agreements, which it hopes its creditors will address at the time of its completion point. Ethiopia's own estimates suggest that due to exogenous factors the net present value (NPV) of the debt-to-export ratio has risen sharply since the HIPC decision point in November 2001. These estimates indicate that the NPV of the debt-to-export ratio will rise to well over 200 per cent in 2003/04, which, according to the

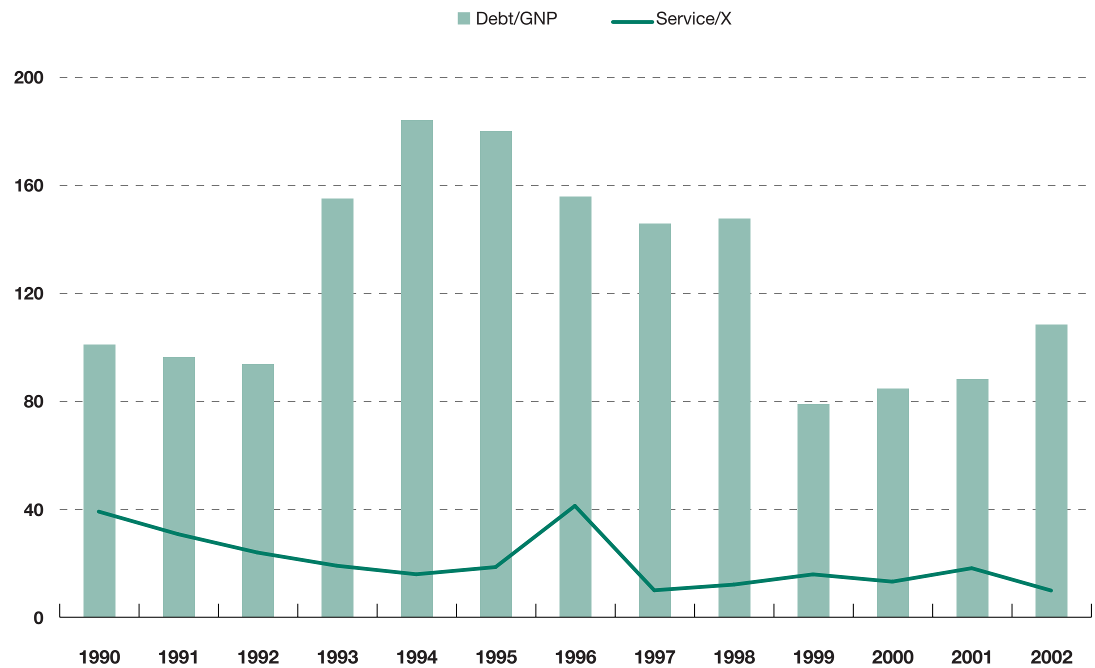
Table 3 - **Current Account** (percentage of GDP)

	1995/96	1999/2000	2000/01	2001/02	2002/03(e)	2003/04(p)	2004/05(p)
Trade Balance	-12.2	-17.2	-17.4	-20.9	-23.7	-24.7	-24.5
Exports of goods (f.o.b)	6.9	7.4	6.9	7.1	7.4	7.4	7.5
Imports of goods (f.o.b)	-19.1	-24.7	-24.3	-28.1	-31.1	-32.1	-32.1
Services	2.2	2.3	2.1	2.5			
Factor income,	-0.7	-0.9	-0.9	-0.7			
Current transfers	11.0	10.7	11.9	13.0			
Current account balance	**0.3**	**-5.1**	**-4.3**	**-6.1**			

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

government, should give Ethiopia more relief. Ethiopia is also making progress in bilateral negotiations with non-Paris-Club creditors, with whom it is seeking debt-rescheduling on terms at least comparable to those given by the Paris Club. External debt management policies restrict new borrowing to concessional credits. The government is also committed to the policy that the public sector neither contract nor guarantee any new loans on non-concessional terms. This policy, however, excludes new debt incurred by Ethiopian Airways. In addition, the government is committed to not accumulating any external arrears at any time.

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



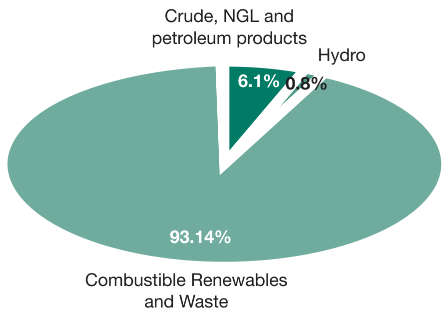
Source: World Bank.

Structural Issues

Efforts at structural reforms have been maintained since 1992. Particularly since the end of the border conflict with Eritrea in December 2000, considerable progress has been made towards institutional reforms. The government's ongoing reform programme focuses on six main areas: civil service reform; capacity building in key ministries, the judicial system, and at regional and district levels; agricultural reform, to improve the efficiency of the agricultural-input market; legal and regulatory reform; the restructuring of utilities; and the privatisation of parastatals. In addition, the drought in the last two years has encouraged further reforms to ensure food security. The government has made progress in promoting private-sector participation in the economy. In 2003, a new investment code was enacted to make the economy more investor-friendly. The burden of business licensing requirements was reduced; access to land was facilitated through land leasing; and the private-public consultative process was strengthened. However, the response to these measures in terms of investment flows remains muted as Ethiopia has not recently derived any major foreign private investment.

The national energy policy is aimed at strengthening the sector through the indigenous, balanced and equitable development of alternative energy resources, such as hydro, geothermal, natural gas and coal energies. In addition, the policy envisages institutional reform

Figure 7 - **Structure of Domestic Energy Supply in 2001**



Source: International Energy Agency.

and technical capacity building to develop the regulatory capabilities of the government, build national capabilities in engineering, construction, operation and maintenance, and gradually enhance local capabilities to manufacture electrical equipment and appliances. The government has developed a Five Year Development Programme (2001-2005), to guide its activities in the energy sector. In the longer term, the government also has a 25-year plan to develop energy management to meet the needs of the country. The Ministry of Rural Development and the Ministry of Infrastructure Development are the federal bodies responsible for the energy sector. A draft proclamation is currently being discussed to merge both ministries.

Energy consumption is very low, with an estimated total per capita consumption of only about 0.2 TOE. Energy consumption relies heavily on biomass sources, which constitute about 93 per cent of the total. However, in the last few years there has been a major increase in the demand for petroleum, as well as electricity. This has reduced the share of biomass in the total energy demand from 93 per cent in 1997 to about 90 per cent in 2002. Most households use energy with high wastage due to lack of skill and appropriate technology dissemination for energy-saving fuel mechanisms. Consequently, this has contributed to deforestation and the degradation of natural resources. From 1992-2002, the annual average growth rate in energy demand was estimated at 3 per cent. Over the same period, the demand for petroleum products grew by an annual average rate of 7.9 per cent, while those of electricity and biomass grew by 8.7 per cent and 2.6 per cent respectively.

The national economic policy requires that existing electric power generation facilities remain under government holding. However, the government has created enabling conditions for joint-ownership in large investments, and technological inputs to develop available energy resources. With this view, the policy acknowledges the positive role of private investors (individually or in partnership) in generating electric power and/or in providing customer service. However, the role played by private investors in the electricity sector is quite limited. The Ethiopian Electricity Agency (EEA), a governmental body, issues licenses, sets standards, and controls and establishes the principles of third party access to the grid to facilitate private investment. Currently, the EEA allows private investors to participate in generating an electrical energy supply with a capacity of up to 25 MW for domestic investors and above 25 MW for foreign investors. The EEA also allows the use of diesel, coal, gas, hydro and other sources of energy, and provides duty and profit tax exemptions. The government has adopted a two-track strategy comprising grid extension and isolated electrification by the private sector with an objective of improving rural access to electricity.

This strategy is in response to the fact that access to electricity is extremely limited, restricted mainly to urban centres, and reaches only about one per cent of the population (600 000 clients in 350 towns) within a 100 km radius of the capital. The current situation exists despite the great potential capability to produce about 160 000 GWh of hydropower per year. Currently, only about 2 000 GWh of electric power is generated each year, for an installed power capacity of about 750 MW, to be increased after completion of ongoing facility developments. This is made up of an interconnected system (ICS), which accounts for about 98 per cent of the total supply, and a self-contained system (SCS) responsible for the remaining 2 per cent. Electricity through the ICS is generated through hydro-power (93 per cent) and thermal (7 per cent). The SCS has a total of 45 diesel and 3 mini hydro plants.

Measures to strengthen the banking system and improve the competitiveness of the financial sector continue to be implemented. A major drawback to competitiveness in the sector remains the continued non-entry of foreign banks. The government's position continues to prioritise strengthening the financial sector and enhancing the supervisory capacity of the central bank – the National Bank of Ethiopia (NBE). In August 2002, the authorities adopted a new directive for the provisioning of banks for non-performing loans (NPLs) and troubled debt in line with international best practices. Full implementation of these measures began in January 2004. In 2003 the government took steps to strengthen the NBE by undertaking a comprehensive study of the bank. The government also committed itself to revising the Banking Act, in order to increase the autonomy of the NBE. The Commercial Bank of Ethiopia (CBE) still dominates the financial market with over 80 per cent of bank deposits and about 60 per cent of bank loans. This dominance continues to undermine efficiency in the financial sector. An independent audit of the CBE was carried out in 2003, and the authorities agreed to adopt and implement a detailed financial restructuring plan for the bank. The plan establishes a clear time frame for reducing the NPL of the CBE, estimated at 59 per cent of total loans at end-2002, to 20 per cent, and also for raising the capital adequacy ratio, estimated at 8.3 per cent at the end of 2002, to 10 per cent by June 2004. Similarly, the government is restructuring other financial entities. The Construction and Business Bank (CBB) was brought to the point of sale, by floating 100 per cent of its shares to the Ethiopian public. However, due to the lack of audited accounts, the offer was withdrawn. The government resolved this issue and the Bank was re-offered for sale to the public in 2003.

Political and Social Context

Ethiopia is struggling to maintain its democracy. Since parliamentary elections were held in 2002, the opposition has made accusations of harassment by the government. Local elections held in 2001 were marred by harassment in most constituencies, which led the opposition candidates to revoke their participation in the elections. In the lead up to the next general elections, concern of intensified political oppression remains rife. Furthermore, the federation continues to be troubled by considerable rebel activity, with groups such as the Ogaden National Liberation front, the Oromo Liberation Front and the Sidama Liberation Front seeking separation. While there is currently no apparent threat to the federation, the government remains obliged to tackle the fundamental political problems behind the rebel activity and to secure sustainable peace and stability. On the other hand, relations with neighbours have improved markedly since the end of the border conflict with Eritrea. Although there is still some tension, as the actual border demarcation has not been effected and normalisation of relations is yet to be achieved, peace continues to prevail due to the efforts of both countries and the UN peace mission in Ethiopia and Eritrea.

Poverty and poverty-related issues are most crucial, as the country remains one of the poorest in the world. The extreme poverty is exacerbated by a high level of vulnerability and the large variance in levels of essential food consumption. For most of the poor, food security, even in times of good weather, is a source of anxiety as structural and persistent food insecurity affects about 5 million poor people every year. Although the majority of the people affected by food insecurity live in rural areas, food insecurity is also emerging as a growing urban problem due largely to urban unemployment. Over the last few years, other factors have made it increasingly difficult for households to manage their own food security. These include collapsing coffee prices, slumping livestock exports and the growing spectre of HIV/AIDS. The HIV/AIDS pandemic is aggravated by other poverty-related factors, such as high unemployment, increased prostitution, and the high rate of migration caused by natural devastation.

The government has positioned poverty reduction at the centre of its medium-term growth strategy, as outlined in the country's Poverty Reduction Strategy Paper (PRSP). The overriding objective is to reduce poverty while maintaining macroeconomic stability. The PRSP directly targets the poor and vulnerable by focusing development on the agricultural sector, which is the source of livelihood for 85 per cent of the population, in the hope of ensuring food security. The government has established 2005 as its target date to reduce the poverty head count ratio by about 10 per cent.

Ethiopia's health system is reeling under the weight of the population's health needs rising faster than the allocation of resources. Although the government's recent targeting of poverty-related expenditures has reflected a real per capita expenditure increase in the health sector, given the low expenditure levels of the past, reversing past trends will take longer. Real per capita expenditure, which had declined by nearly a quarter between 1998/99 and 1999/00, had risen by nearly 50 per cent by 2002. However, only about 46 per cent of the population currently has access to health coverage. There are approximately four physicians per 100 000 people; safe water reaches only 24 per cent of the population, while access to sanitation is limited to only 15 per cent of the population. Inadequate facilities, faulty equipment, and shortages of essential drugs continue to be problematic as well. The government's health strategy is focused on a Health Extension Package (HEP), a community-based health delivery system aimed at creating healthy environments as well as healthy living. The main objective of the HEP is to improve access and equity through community health services with a strong focus on sustained, preventive health actions and increased health awareness. However, the existing and newly constructed health care institutions are still too few to meet the needs of the population; some are inaccessible due to lack of roads. Additionally, fees collected by these institutions are remitted to the treasury, making it impossible for the institutions to use available resources efficiently for local problems.

The spread of HIV/AIDS, with about 10.6 per cent of the adult population HIV positive, is a major challenge to the health system. The government has adopted specific measures to tackle some of the major health problems in the country. To combat the HIV/AIDS menace, it has developed a National Response Strategic Framework to HIV/AIDS, covering the period 2002-2004. The target is to reduce the level of HIV transmission by 25 per cent in five years. Also, a multi-sectoral HIV/AIDS programme is being implemented. The government is also directly funding NGOs and Civil Society Organisations (CSOs) involved in HIV/AIDS related activities on a matching grant basis. HIV/AIDS Councils have also been established at federal, regional and district levels to monitor programme implementation. The implementation of the HEP, which started in 2002/03, has enjoyed some success. The coverage of DPT3 reached 51.5 per cent in 2002 from 27 per cent in 2001. An effort to curtail the spread of HIV/AIDS through safe-sex campaigns, specifically by distributing condoms, has increased: 50 million condoms were distributed in 2000, 57 million in 2001 and an estimated 65 million in 2002.

Ethiopia's education system offers one of the lowest enrolment and literacy rates in sub-Saharan Africa. The government has responded with a holistic plan for the expansion and development of the sector through its Education Sector Development Programme (ESDP). Under the programme, and as part of the recent targeting of poverty-related expenditure, real per capita expenditure has risen sharply. Real per capita expenditure that declined by about 6 per cent between 1998/99 and 1999/2000, rose by about 30 per cent in 2000/01, and by a further 11 per cent in 2001/02. In 2002/03, real expenditure on education increased by 10 per cent. The share of education expenditure in total GDP thus rose from 2.6 per cent in 2000/01 to 3.4 per cent in 2002/03. In response to these increases in expenditure, significant improvement in primary school enrolment has been recorded over the past four years. The government's target under the PRSP is to achieve a gross enrolment ratio of 65 per cent with regard to primary enrolment by 2004/05, and the success achieved thus far suggests they will attain their target. The February 2001 review of the Education Sector Development Programme revealed that the net primary school enrolment ratio for girls increased from 21.5 per cent in 1996 to 36.6 per cent in 1999, while for boys the increase was from 32.3 per cent to 51.2 per cent. In addition, some success has been recorded in reducing the illiteracy rate in the country, with the total illiteracy rate falling from 61 per cent in 2000 to 58.5 per cent in 2002. However, the education system continues to be characterised by both quantitative and qualitative limitations including shortage of classrooms, teachers, essential textbooks and other learning materials, poor curriculum, and high repetition and drop out rates, especially among girls. In general, only about 50 per cent of all pupils who enrol in primary schools successfully complete the full cycle.