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Statement by Ms. Lundsager and Mr. John on The Federal Democratic Republic of Ethiopia (Preliminary) Executive Board Meeting 04/86 September 13, 2004

Ethiopia's pursuit of generally prudent policies is commendable and has contributed to a more stable macroeconomic environment. As we have emphasized throughout the program, more aggressive steps on the structural front, including in areas of World Bank expertise, would help achieve higher sustained growth, strengthen the country's resilience to shocks, and improve upon troubling poverty indicators. We welcome the recognition in Mr. Usman's helpful statement that a strong reform effort is still needed. Among the many challenges facing Ethiopia is a still high debt level, and the relatively rosy scenario in the new DSA raises serious concerns about the proposed low-income debt sustainability framework's compatibility with HIPC.

Ex Post Assessment and Future Engagement

The ex post assessment captures how Fund programs have helped Ethiopia achieve a measure of macroeconomic stability although much remains undone, particularly to boost growth and exports. The report's candor on the disappointing results on growth, poverty reduction, and rising debt is appreciated. The regional comparisons help show where greater advances could have been made. Reducing vulnerability to weather-related shocks given their regularity, increasing agricultural productivity and food security, and undertaking further liberalization, including in the financial sector, to support private sector growth should be top priorities.

The important recommendation to use more realistic projections for growth, revenue, and grants seem to have been taken much more to heart by staff than the authorities as evidenced by their very different assumptions and the authorities' request for a doubled aid scenario. The more optimistic scenario does not seem realistic, and we note the ex post assessment's comments that Ethiopia's before-grants deficit is high by international standards, that its before-grants current account deficit is twice the PRGF average, and that it is already highly aid-dependent. We encourage publication of the assessment as well as the staff report to facilitate public understanding of key economic issues in Ethiopia.

The ex post assessment does a good job of outlining considerations for future Fund involvement and stressing the importance of a more ambitious structural agenda, especially with the World Bank. We welcome the strong emphasis on avoiding borrowing even on concessional terms. We also note the authorities' statements that IMF involvement is needed primarily for the policy framework and signaling purposes.

Fiscal Policy

While the fiscal deficit was lower than had been projected for 2003/04, it remains large and will likely result in higher levels of domestic borrowing that crowd out credit to the private sector, add to the debt burden, and complicate efforts to reduce inflation. We are particularly concerned that a 2 percent of GDP fiscal gap remains to be filled for 2004/05 and urge the authorities to identify savings or grant resources to avoid a destabilizing recourse to domestic financing. Measures to enhance revenues and limit defense spending should be pursued to strengthen the country's fiscal stance. We welcome progress made in strengthening tax and customs administration.

While we welcome the authorities' shift toward greater poverty-related expenditures, we caution against assumptions of high levels of external assistance, particularly given the continued stalemate over the border dispute and upcoming elections in 2005. A resolution of the dispute, combined with a greater fiscal effort by the authorities and measures to improve public expenditure management, should enhance donor confidence. Like the staff, we welcome the initiatives being implemented to strengthen food security. We welcome the emphasis here and elsewhere in the staff report on the need for grants so as not to add to the debt burden and to provide some cushion against future shocks.

Debt Sustainability

The DSA conveys somewhat conflicting messages: the second bullet on page two urges grants while the third bullet on the same page indicates that Ethiopia can handle 200 percent NPV debt-to-exports. This is just months after topping up assistance was provided at completion point to reach a ratio of 150 percent. While we note the correction that was issued, we still find this DSA's bottom line to be a green light for more borrowing. Given the strong concerns in the EPA regarding debt levels, absorptive capacity, aid dependency, and insufficient structural reforms, we should not be sending the signal that more borrowing is appropriate.

We understand we will shortly have a discussion of how to evaluate debt sustainability going forward and thus were surprised to see application of the "indicative policy-based thresholds" in a country paper prior to Board consideration of the analytical framework. In anticipation of that discussion, we would stress our deep concern about the implications of applying the proposed framework, particularly while HIPC is still being implemented. The proposed methodology for determining the NPV of debt-to-exports has the potential to produce debt ratios highly divergent from HIPC calculations. Such conflicting messages are not helpful and we should aim to avoid cases in which exchange rate, discount rate, or export level assumptions differ for debt relief and new lending purposes. As illustrated in the Table 1 of the DSA, using the new methodology creates a 25 percentage point difference in 2004 relative to the estimate in the completion point document.

Monetary and Exchange Rate Policy

More restrained fiscal policy is needed to address monetary financing of the deficit and inflationary pressures and we share the staff's view that the monetary program should be tighter. Furthermore, in order for monetary policy to be effective, measures need to be taken to strengthen the autonomy of the Central Bank. We agree with the staff's recommendation that the exchange rate should be allowed to be market-determined to help improve Ethiopia's ability to weather shocks and to guard against losses in competitiveness. The implementation of almost all safeguards recommendations is commendable, and we urge progress on the outstanding measures.

Structural and Financial Sector Reform

We continue to emphasize the importance of increasing the role of the private sector in the economy, including in the financial sector. Strengthening public banks alone will not increase efficiency and promote competition. Making it easier for other banks, including foreign banks, to enter the market and completing the privatization of state-owned banks, would improve financial intermediation and help spur private sector-led growth. We welcome progress made on the long-delayed restructuring of CBE and urge full implementation of agreed reforms. While falling recently, the level of non-performing loans remains high and further improvement is needed. Removing impediments to bank lending would also help, and we continue to stress the importance of allowing land to be used as collateral. Increasing access to credit, especially to the rural poor will help boost agricultural productivity and ultimately growth.