FOR AGENDA

EBS/81/176

CONFIDENTIAL

August 21, 1981

To: Members of the Executive Board

From: The Acting Secretary

Subject: Ethiopia - Review of Stand-By Arrangement

Attached for consideration by the Executive Directors is a paper on a review of the stand-by arrangement for Ethiopia. A draft decision modifying paragraph 4(a) of the stand-by arrangement appears on page 15.

This subject has been tentatively scheduled for discussion on Wednesday, September 9, 1981.

Att: (1)

CONFIDENTIAL

INTERNATIONAL MONETARY FUND

Ethiopia - Review of Stand-by Arrangement

Prepared by the African Department and the Exchange and Trade Relations Department

(In consultation with the Legal Department and Treasurer's Departments)

Approved by J.B. Zulu and S. Kanesa-Thasan

August 19, 1981

I. Introduction

On May 8, 1981 the Fund approved a stand-by arrangement for Ethiopia in an amount equivalent to SDR 67.5 million (125 per cent of quota), of which SDR 34.98 (64.8 per cent of quota) represented ordinary resources (EBS/81/98, Supplement 1). The stand-by arrangement was in support of a financial program covering the 18-month period ending June 30, 1982. So far, Ethiopia has purchased SDR 24.6 million.

In accordance with the terms of the stand-by arrangement a Fund mission 1/ visited Addis Ababa in the period June 9-25 to review with the Government of Ethiopia performance under the financial program and establish a ceiling on total domestic credit and net credit to the Government for the period of the stand-by arrangement beyond June 30, 1981. In the annexed letter, dated June 24, 1981, the Minister of Finance and the Governor of the National Bank of Ethiopia review the progress made to date in implementing the program, specify the measures recently taken by the authorities, and describe the policies to be followed and the performance criteria to be met during July 1981-June 1982. Table 1 presents Fund transactions with Ethiopia during the program period. Fund holdings of Ethiopian birr, as of June 30, 1981, amounted to 230.4 per cent of quota; excluding purchases under special facilities, Fund holdings amounted to 130.4 per cent of quota. 2/ Provided the performance criteria are met, Fund holdings, excluding purchases under the special facilities, but including purchases under the enlarged access, will increase to 225.0 per cent of quota by the end of the stand-by period. A summary of Ethiopia's relations with the Fund is provided in Attachment I.

1/ The mission consisted of Messrs. Makalou (head-AFR), Callender (AFR), Briffaux (AFR), Boonekamp (ETR), Feltenstein (RES), and Mrs. Nairn (AFR-secretary).

2/ Purchases of SDR 4.1 million under the reserve tranche were made in July 1981.

Table 1. Ethiopia: Schedule of Purchases
May 1, 1981-June 30, 1982

(In millions of SDRs and as per cent of quota) 1/

By end of period	Purchases: Total	Purchases: of which: Enlarged Access resources	Total Fund holdings 2/	Fund holdings as per cent of quota: Total	Fund holdings as per cent of quota: Tranche holdings and including enlarged resources 3/
1981					
May-July	42.60 4/	6.886	128.50	238.0	138.0
August	11.75 5/	6.409	140.25	259.7	159.7
November	11.75 5/	6.409	152.00	281.5	181.5
1982					
February	11.75 5/	6.409	163.75	303.2	203.2
May	11.75 5/	6.410	175.50	325.0	225.0
June	--	--	175.50	325.0	225.0

Source: Data provided by the Treasurer's Department.

1/ SDR = Br 2.3871 at end-June 1981.
2/ There are no scheduled repurchases during the period May 1, 1981-June 30, 1982.
3/ Excluding purchases under the compensatory financing facility.
4/ This reflects purchases of SDR 4.10 million under the reserve tranche, SDR 20.50 million under the stand-by arrangement (approximately equal to the first credit tranche plus 12.5 per cent of quota), and SDR 18.00 million under the compensatory financing facility.
5/ Reflects purchases under the stand-by arrangement at least six weeks after completion of the quarter for which performance criteria have to be observed.

II. Performance Under the Stand-By Program

The three main objectives of the stand-by program are to sustain a reasonable rate of economic growth, strengthen overall fiscal performance, and contribute toward the creation of the necessary conditions for an improvement of the balance of payments over the medium term. To date, performance under the program has been broadly satisfactory. It is likely that Ethiopia will meet the performance criteria in the form of ceilings on total domestic credit and net credit to the Government for the period ending June 30, 1981. Real GDP growth has slowed but has remained above population growth; program targets for the government budget have, in the main, been met; the balance of payments situation was considerably more favorable than originally projected, and since March 27, 1981 petroleum subsidies have been completely eliminated. Table 2 provides an overview of important economic indicators in recent years.

Ethiopia's balance of payments came under severe pressure during the first half of fiscal year 1980/81, as the prices of most export commodities, particularly coffee, declined and import prices rose. Consequently, the Ethiopian authorities took measures to reduce the growth of imports through credit and investment restraint, to increase both noncoffee exports and the inflow of foreign aid, and to pursue cautious demand-management policies. These actions resulted in a balance of payments surplus of SDR 16 million in the second half of the fiscal year, as compared with the program target of containing the deficit to SDR 26 million. For the year as a whole, as Table 3 shows, the balance of payments deficit was limited to SDR 75 million (2.2 per cent of GDP), which compares favorably with an anticipated deficit of SDR 115 million (3.3 per cent of GDP) under the program. During 1980/81 the current account deficit is estimated to have risen to SDR 237 million, from SDR 144 million in 1979/80; the increase in the deficit is due entirely to a sharp (24 per cent) deterioration in the terms of trade. Despite a 4 per cent increase in the volume of coffee exports, the value of total exports fell by 13 per cent, reflecting a 25 per cent decline in coffee prices. Moreover, although real imports declined by 3 per cent, the value of imports rose by 8 per cent, due to sharply higher prices for petroleum products. The capital account also worsened in 1980/81, as net official capital inflows declined. These developments were reflected in a decline of Ethiopia's net foreign assets from the equivalent of 3.1 months of imports in June 1980 to 1.4 months of imports in June 1981; the latter figure compares with an initial program projection of net foreign assets sufficient to provide 0.5 months of imports in June 1981.

These external developments adversely affected the growth of the Ethiopian economy, particularly in the industrial and construction sectors. The limited availability of foreign exchange slowed the importation of necessary inputs for the construction sector and impeded the expansion of industrial capacity, which is close to being fully utilized. Overall, real gross domestic output grew by 4 per cent compared with 5.6 per cent in 1979/80. Agricultural production rose by more than 5 per cent. The rate

Table 2. Ethiopia: Selected Indicators, 1978/79-1981/82

(Ratios in per cent; otherwise in units specified)

Fiscal year (ended July 6)	1978/79	1979/80	1980/81 Provisional	1981/82 Staff forecast
Real GDP growth	5.3	5.6	4.0	5.0
Investment/GDP	6.3	10.4	10.7	11.8
Overall budgetary deficit/GDP	3.3	4.5	3.8	5.6
Balance of payments deficit/GDP	-1.2	-1.0	-2.2	-1.9
Current account deficit/GDP 1/	-4.8	-4.6	-6.9	-7.4
External debt/GDP	15.1	16.8	17.8	19.1
Debt service ratio	6.0	5.0	6.5	7.1
Exports/GDP	9.4	11.6	9.7	8.6
Imports/GDP	15.3	17.5	17.9	17.4
Coffee exports/Total exports	72.7	64.3	57.2	47.0
Oil imports/Export earnings	30.5	38.6	58.6	62.9
Terms of trade index (1976/77 = 100)	62.7	74.9	57.2	47.9
Net foreign assets in millions of SDRs (end of period)	169.4	135.6	70.6	-4.0
in months of imports	4.5	3.1	1.4	-0.1

Sources: Ethiopian authorities; and staff estimates.

1/ Excludes net official transfers.

Table 3. Ethiopia: Balance of Payments, 1976/77-1981/82

(In millions of SDRs)

Fiscal Year 1/	1976/77	1977/78	1978/79	1979/80	1980/81	1981/82 Staff forecast
Trade balance	-110.3	-183.3	-178.8	-180.4	-284.5	-367.8
Exports, f.o.b.	270.3	270.1	281.0	364.1 2/	334.4	364.5
Coffee	(171.0)	(206.4)	(204.3)	(234.3)	(191.5)	(171.1)
Other	(99.3)	(63.7)	(76.7)	(119.9)	(142.9)	(193.4)
Imports, c.i.f.	-380.6	-453.4	-459.8	-544.5	-618.9	-732.3
Net services	18.3	16.5	16.4	21.0	27.5	34.6
Travel	-1.2	-1.1	1.6	2.9	2.0	3.8
Other transportation	11.7	11.6	6.8	8.3	20.8	25.0
Investment income	-1.6	-3.7	-2.0	5.6	-2.0	-3.3
Government, n.i.e.	9.2	4.5 3/	4.6	2.5	3.9	5.0
Other services	0.2	5.2	5.4	1.7	2.8	4.1
Private transfers	14.3	12.4	18.2	15.3	19.6	22.9
Current account balance	-77.7	-154.4	-144.2	-144.1	-237.4	-310.3
Public transfers	36.8	44.3	46.6	46.0	55.9	83.3
Nonmonetary capital (net)	46.9	19.4	42.2	62.8	55.8	147.9
Private long-term	4.9	2.9	--	--	--	--
Public long-term	38.9	27.7	57.1	73.8	60.7	152.1
Short-term	3.1	-11.2	-14.9	-11.0	-4.9	-4.2
Net errors and omissions	14.5	-14.2	16.1	1.5	27.8	--
SDR allocations	--	--	3.6	3.7	3.6	--
Revaluation of reserves 4/	--	--	--	--	19.1	--
Overall balance	20.5	-104.9	-35.7	-30.1	-75.2	-79.1
Net monetary movements 5/	-20.5	104.9	35.7	30.1	75.2	79.1
Exchange rates 6/	2.3916	2.4836	2.6516	2.6965	2.5500	2.4000

Sources: National Bank of Ethiopia, and staff estimates.
1/ Data cover year ended July 6 where available, otherwise June 30.
2/ Includes SDR 9.9 million of nonmonetary gold.
3/ "Other government service payments" reclassified from "other services" to "government, n.i.e." beginning in 1977/78.
4/ Profits from the sale of 48,430 ounces of gold.
5/ Increases in net assets denoted by a minus sign.
6/ Birr per SDR (average for period).

of increase in domestic prices was lower than in previous years, reflecting both the increased supply of domestic food grains and improvements in the distribution system.

Budgetary performance in 1980/81 was broadly as envisaged under the program (Table 4) and reflects a considerable adjustment effort. The overall budgetary deficit is estimated to have declined from Br 377.4 million (4.5 per cent of GDP) in 1979/80 to Br 330.5 million (3.8 per cent of GDP) in 1980/81. External factors also impinged upon the budget. The receipts from taxes on foreign trade declined by 15 per cent, largely as a result of a 45 per cent decline in coffee export tax receipts. Nevertheless, total revenue is estimated to have increased by 2.3 per cent, due to an improvement in both tax administration and the collection of government revenues. Government current expenditure increased by less than 1 per cent, as the Government sharply reduced all subsidies, totally eliminated the petroleum subsidy on March 27, 1981, and continued to restrain current expenditure on goods and services. These developments in the current budget resulted in a surplus equivalent to 2.3 per cent of revenue, as compared with a surplus of 0.8 per cent of revenue in 1979/80 and the program target target of 1.7 per cent. Capital expenditure showed an actual decline of 5.6 per cent, partly reflecting lags in the disbursement of foreign aid. Although the overall budgetary deficit declined from 1979/80, the shortfall in foreign assistance required an increase of 3 per cent in the domestic financing needs of the Government. Net domestic credit by the banking system to the Government, however, is expected to have been within the program ceiling of Br 1,198.8 million as of July 6, 1981.

Domestic credit, which grew by 24 per cent in 1979/80, is estimated to have grown by 14 per cent in 1980/81, to Br 2,928 million, and is consequently expected to be within its program ceiling of Br 2,935 million at the end of June 30, 1981 (Table 5). The growth of credit to the non-central government sectors slowed from 32 per cent in 1979/80 to 9 per cent in 1980/81. These reduced rates of credit expansion reflect the slow growth of import trade and the cautious credit policies of the monetary authorities. Money and quasi-money showed a decline of 4.3 per cent.

III. Economic and Financial Program for 1981/82

Ethiopia's economic and financial prospects for the fiscal year 1981/82 will continue to be dominated by developments in the balance of payments. While real GDP is estimated to increase by 5 per cent, the realization of that growth rate will depend upon the acquisition of the necessary foreign financing to implement planned public investment of Br 1.2 billion and the curtailment of the trade deficit. Despite an anticipated improvement in net services and private transfers, the current account deficit is expected to widen to SDR 310 million, largely as the result of an anticipated further decline of 16 per cent in the terms of trade. Overall, the balance of payments deficit is expected to be about SDR 80 million, which is in line

Table 4. Ethiopia: Summary of Central Government Finances, 1978/79-1981/82 1/

	1978/79 Actuals	1979/80 Actuals 2/	1980/81 Revised budget 3/	1980/81 Estimated actuals	1981/82 Budget
	(In millions of birr)				
Revenue	1,383.8	1,570.0	1,573.0	1,606.5	1,676.0
Current expenditures	1,290.6	1,557.7	1,546.4	1,569.1	1,658.0
Current surplus or deficit (-)	93.2	12.3	26.6	37.4	18.0
Capital expenditure	360.0	389.7	395.3	367.9	582.0
Overall deficit (-)	-266.8	-377.4	-368.7	-330.5	-564.0
External borrowing (net)	164.4	142.4	112.0	89.5	300.0
Loans and credits	(179.4)	(158.3)	(130.0)	(105.5)	(325.0)
Repayments	(-15.0)	(-15.9)	(-18.0)	(-16.0)	(-25.0)
Domestic financing (net)	102.4	235.0	256.7	241.0	264.0
Banking system (net)	89.0	189.6	230.7	205.0	228.0
Cash basis	(96.0)	(106.2)	(230.7)	(227.5)	(228.0)
Adjustment for accrual basis	(-6.5)	(83.4)	(--)	(-22.5)	(--)
Pension Commission and other	12.9	45.4	26.0	36.0	36.0
	(In per cent)				
Changes over the previous year					
Revenue	16.7	13.5	0.2	2.3	4.3
Current expenditure	-3.0	20.7	-0.7	0.7	5.7
Capital expenditure	34.7	82.	1.0	-5.6	58.2
Ratio of current surplus or deficit (-) to revenue	6.7	0.8	1.7	2.3	1.1
Ratios to estimated GDP					
Revenue	17.4	18.6	17.9	18.2	16.5
Current expenditure	16.2	18.5	17.6	17.8	16.4
Current surplus or deficit (-)	1.2	--	0.3	0.4	0.2
Capital expenditure	4.5	4.6	4.5	4.2	5.7
Overall deficit (-)	-3.3	-4.5	4.2	-3.8	-5.6
External borrowing (net)	2.1	1.7	1.3	1.0	3.0
Bank financing (net)	1.1	2.2	2.6	2.3	2.2

Sources: Data provided by the Central Planning Supreme Council (C.P.S.C.) and the Ministry of Finance; program data for 1980/81 and 1981/82.

1/ Data on an accrual basis.
2/ Revised; they differ slightly from those presented in EBS/81/98, Table 5.
3/ The preprogram budget is documented in EBS/81/98, Table 5.

Table 5. Ethiopia: Monetary Survey, June 1979-June 1982

(In millions of birr)

	1979		1980			1981	1982
	June	December	June	December	March	June 30 1/	June
Foreign assets (net)	452.6	410.3	371.7	139.0	142.9	180.0	-10.0
Central bank	270.4	296.2	218.2	101.9	86.0	30.0	...
Commercial bank	182.2	114.1	153.5	37.1	56.9	150.0	...
Domestic credit (net)	2,067.5	2,288.2	2,560.5	2,668.4	2,839.3	2,928.0	3,667.0
Government (net)	862.3	942.7	968.5	1,076.5	1,118.3	1,196.0	1,426.8
Other sectors	1,205.2	1,345.5	1,592.0	1,591.9	1,721.0	1,732.0	2,240.2
Money and quasi-money	1,848.0	1,863.2	2,053.2	1,858.0	1,864.6	1,965.0	2,328.0
Money	1,341.3	1,327.2	1,443.1	1,229.8	1,227.7	1,286.0	...
Quasi-money	506.7	536.0	610.1	628.2	636.9	679.0	...
Long-term foreign loans	19.5	18.4	17.3	16.2	16.2	16.0	16.0
Other items (net)	652.6	816.9	861.7	933.2	1,101.4	1,127.0	1,313.0

Sources: National Bank of Ethiopia; and staff estimates.

1/ Provisional estimates.

with the program target. The deficit may be smaller if the recent recovery in coffee prices is sustained.

1. Production and investment policies

The broad objective of the investment target of Br 1.2 billion for 1981/82 is to expand the economy's productive capacity in a manner which minimizes pressure on the balance of payments over the medium term. To that end the authorities have prepared a list of top priority projects which are intended to minimize capital intensity and import content and emphasize key areas of production, such as essential foodstuffs, basic manufactured consumption goods, non-oil sources of energy, and exportable commodities. More than 60 per cent of the Government's capital budget for 1981/82 is devoted to export-generating and import-substituting projects.

The primary focus of the development effort remains on agriculture, with the aim of achieving self-sufficiency in food grains and a rapid rate of export growth. The policies to achieve this are described in EBS/81/98, and, barring adverse weather conditions, the output of the agricultural sector is expected to grow by roughly 6-7 per cent in 1981/82.

The authorities will continue to accord a high priority to the development and diversification of exports. Coffee marketing operations are being strengthened, measures are being undertaken to increase the proportion of washed and higher-grade coffee in total coffee exports, and the implementation of a spraying program has begun to eradicate coffee berry disease. On the state farms increased emphasis is being given to the production of cotton, sugar, and oilseeds, while in the peasant sector the marketing and distribution of consumer goods is being improved to support the production incentives for cash crops. Major efforts are also being made to expand exports of packaged and processed meat products. Measures to increase the quantity and quality of processed hides and skins will be continued. In addition, the authorities will continue to review ex-farm prices periodically to encourage the production of food and export crops.

The main areas of industrial expansion will be in import-substitution industries, such as processed foodstuffs, beverages, textiles, cement, and sugar. Emphasis will be given to small- and medium-scale industrial projects which rely largely on labor and domestic raw materials. The authorities have taken steps to increase the exportation of handicrafts by encouraging the voluntary establishment of producers' cooperatives, which they support with technical, credit, and other facilities.

The Government's policies on energy, consumer subsidies, wages, and public enterprises remain as those described in EBS/81/98. Energy policies will emphasize investments in non-oil sources of energy and conservation. Subsidies paid through the budget will be reduced from Br 100 million in 1980/81 to Br 30 million in 1981/82, which will be Br 17 million lower than the original program estimate. Wage policy will continue to be conservative, and increases will be selective in order to encourage efficiency.

However, these increases are not expected to be of a magnitude that will endanger the objective of fiscal policy. Policy with respect to public enterprises will remain such as to make them surplus-generating and self-sustaining units.

2. Domestic financial policies

The authorities had intended to achieve a significant improvement in budgetary performance during fiscal year 1981/82. However, budgetary prospects appear to be less favorable than originally envisaged on account of sharply lower revenues and higher expenditure. Because of an anticipated further decline of 22 per cent in the export price of coffee, and in spite of an 8 per cent increase in the volume of coffee exports, the receipts from the coffee export surtax are expected to be Br 81 million lower than originally anticipated. Despite an anticipated 15 per cent decline in foreign trade tax receipts, current budgetary revenue is estimated to increase by 4.3 per cent to Br 1,676 million in 1981/82. Receipts from domestic taxes are estimated to increase by 18 per cent, largely as a result of improved tax administration and collection and the rationalization of the indirect tax structure. On the other hand, current expenditure is estimated to rise by 5.7 per cent in nominal terms, compared with the projected increase of 2.7 per cent. These developments will result in a current budget surplus of Br 18 million, which would, however, be considerably less than was assumed initially in the program. Moreover, in line with the Government's policy to increase investment, budgetary capital expenditure is projected to increase to Br 582 million in 1981/82. The resultant overall budgetary deficit of Br 564 million represents 5.6 per cent of anticipated GDP, compared with the original program estimate of 2.5 per cent.

The rise in the ratio of the overall budgetary deficit to GDP, will be largely covered by the increase in foreign budgetary support (Table 4). The authorities project that in 1981/82 net foreign budgetary borrowing, which is associated with project implementation, will amount to Br 300 million and that it will meet roughly 53 per cent of the budgetary financing need. The remainder of the budget deficit will be financed by recourse to domestic sources. The increase in the banking system's net credit to the Government during 1981/82 will be limited to 19 per cent. Any net foreign budgetary borrowing in excess of Br 300 million and any bond sales to the Pension Commission above the amount of Br 36 million presently envisaged for 1981/82, will be regarded as falling within the ceilings on net credit to the Government.

For 1981/82 the program specifies a limit on total domestic credit of Br 3,667 million on June 30, 1982; this allows for a 25 per cent expansion in total credit. With the achievement of the program's balance of payments target of an overall deficit of SDR 80 million in 1981/82, this credit ceiling is expected to lead to an increase in broad money of 18.5 per cent in 1981/82. The monetary aggregates are designed to provide the liquidity for a targeted increase of 5 per cent in real GDP and 15 per cent in nominal GDP.

During 1981/82 the Government will continue to implement its planned expansion of banking and other financial institutions, in order to increase the mobilization of domestic savings. With regard to interest rates, the Ethiopian authorities remain of the opinion that a general increase in the rates would be of limited usefulness at present. They indicated, however, that the structure of interest rates would be kept under review and that it would be changed if it seemed likely that the mobilization of savings and the efficiency of the sectoral allocation of credit would thereby be enhanced.

3. External policies

The Ethiopian authorities have taken measures, as described above, to economize on capital and imports and to promote and diversify exports. Unfortunately, during the remainder of the program period the benefits from the measures are likely to be largely offset by an anticipated further decline of 16 per cent in the terms of trade, led by a 22 per cent decline in coffee export prices. During 1981/82 import payments are projected to grow by 11 per cent, which is equivalent to barely 3 per cent in real terms. The fuel bill is expected to be contained to a 10 per cent increase, but it is nevertheless expected to account for almost 63 per cent of forecast export earnings. Import payments for raw materials and semifinished goods are projected to grow by 11 per cent and are based on the minimal needs of Ethiopia's productive sectors. Capital imports are projected to rise rather sharply, but, as a ratio to the investment target, these imports will continue their decline from a peak of 48.3 per cent in 1979/80 to 45 per cent in 1981/82; consumer imports will fall by roughly 10 per cent. Overall, the authorities retain their commitment to moderating the growth of imports through efficient resource allocation and the careful monitoring of stocks and production operations. With respect to exports, the authorities' intentions are to increase the volume of coffee exports and to improve substantially noncoffee export earnings. Real exports, which grew by 5 per per cent in 1980/81, are expected to grow by 13 per cent in 1981/82, with the growth being led by increased exports of coffee, sugar, live animals, oilseed cake, and petroleum products.

The birr remains pegged to the U.S. dollar at the rate of US$1=Br 2.07. Between January 1980 and June 1981, the trade-weighted nominal effective exchange rate has appreciated by 12 per cent; during the same period, the real trade-weighted index appears to have remained constant. The authorities have initiated a study on the possibility of changing the present peg to one based on a basket of currencies. The parameters of the study were discussed with the Fund mission, and, although no conclusions have yet been drawn, it is expected that, at the time of the program review mission in February 1982, decisions will be made as to the appropriate exchange arrangement for Ethiopia. The mission also discussed Ethiopia's restrictive system with the authorities. In their opinion, because of the extremely tight foreign exchange situation, it would not now be feasible to relax the current exchange and trade restrictions; they remain intent upon doing so, however, once the level of net foreign assets is again sufficient to cover approximately three months of imports.

The authorities assured the mission that the Fund's information on the external debt situation is complete and comprehensive. It is estimated that at the end of fiscal year 1980/81 disbursed external debt amounted to Br 1,571.6 million, equivalent to 17.8 per cent of GDP, on which the debt service ratio was 6.5 per cent. Largely based on investment projects for which foreign resources are already committed, it is expected that Br 365 million of foreign loans will be disbursed in 1981/82; the external debt to GDP ratio at the end of the program period would then be 19.1 per cent and the associated debt service ratio would be 7.1 per cent. With regard to the issue of compensation for nationalized industries, the authorities indicated that one American and three Japanese companies had already been compensated and that other claims are currently being processed.

4. Performance criteria

The program includes as performance criteria: (1) quarterly ceilings on total domestic bank credit, with quarterly subceilings on net credit to the Government; and (2) the standard provision relating to multiple currency practices, bilateral payments arrangements, and restrictions on payments and transfers for current international transactions and on imports for balance of payments reasons (paragraph 23 of the Letter of Intent, dated April 7, 1981). The quantitative performance criteria are shown in Table 6. There

Table 6. Ethiopia: Quantitative Performance Criteria, 1981-82

(In millions of birr)

	1981			1982	
	June	September	December	March	June
Domestic credit	2,935.0	3,148.0	3,368.0	3,587.0	3,667.0
Claims on Government (net) 1/	1,198.8 2/	1,316.8 3/	1,376.8 3/	1,406.8 3/	1,426.8 3/

Sources: Ethiopia's Letter of Intent dated April 7, 1981, and Letter of Intent dated June 24, 1981.

1/ Consists of net claims on Government by the National Bank of Ethiopia and the Commercial Bank of Ethiopia as defined in the Letter of Intent dated April 7, 1981.
2/ Applies to July 6, end of fiscal year.
3/ These ceilings will be reduced by any excess of net foreign borrowing by the Central Government above the level of Br 300 million and by additional domestic sales of bonds to the Pension Commission above the level of Br 36 million.

is also an understanding that, in conjunction with the Article IV consultation discussions, a stand-by review mission will visit Addis Ababa in February 1982.

IV. Staff Appraisal and Proposed Decision

Economic performance during the first part of the stand-by program has been generally satisfactory. The performance criteria for June 1981, in the form of ceilings on total domestic credit and net domestic credit to the Government, are likely to be met. The growth of real GDP, which during the two-year period ended June 30, 1980 had averaged almost 5.5 per cent per annum, slowed to 4 per cent in 1980/81, but the decline was due in large measure to external factors. Sharply lower world coffee prices resulted in a significant decline in coffee export surtax receipts and hence reduced the availability of counterpart funds necessary for the release of foreign resources to implement the investment program. Further, the decline in net foreign assets, stemming from the 24 per cent deterioration in the terms of trade, prevented the importation of materials in sufficient quantity to sustain the past growth rates, particularly in the industrial and construction sectors. However, because of the cautious demand management policies of the authorities, the balance of payments target for the year ended June 30, 1981 was met. Strict fiscal discipline was also maintained, and accordingly, in line with the program target, the overall budgetary deficit declined from 4.5 per cent of GDP in 1979/80 to 3.8 per cent of GDP in 1980/81. Due largely to the elimination, in late March 1981, of all petroleum subsidies, only 83 per cent of the reduced level of budgetary subsidies anticipated for 1980/81 under the program were actually paid out in 1980/81.

The policies adopted for the fiscal year 1981/82 are a continuation of those initiated in early 1981. Cautious demand-management policies will be followed; fiscal discipline will be maintained; and the investment strategy, within the limits of available resources, will pursue the diversification of both the agricultural base and exports, while economizing on capital and imports. External economic developments will, however, continue to dominate Ethiopia's financial prospects. With respect to the budget the anticipated 22 per cent decline in the world price of coffee will result in a 15 per cent decline in the foreign trade tax receipts in 1981/82. Thus, despite only a modest increase in current expenditure, the current surplus in 1981/82 will amount to just 1.1 per cent of anticipated revenues, compared with the original projection of 10.7 per cent. However, the budgetary prospects may improve if the current recovery in coffee prices is sustained. The investment budget, the implementation of which is vital to the long-term development of the economy, will thus be financed mainly by foreign loans and domestic bank credit. The lack of domestic savings points to the possible need for the introduction of new policy measures. The staff is of the view that interest rates need to be increased in order to mobilize greater amounts of private savings and to use scarce resources more efficiently. Additional tax measures may also have to be taken. The Ethiopian authorities are aware of this and have already improved the administration and collection of direct taxes, and are in the process of rationalizing the indirect tax structure.

Ethiopia's balance of payments is experiencing severe pressure and, on the basis of current projections, will continue to do so during 1981/82. This is to a large extent the consequence of an anticipated 22 per cent decline in the world price of coffee. But for this sharp decline in coffee prices, the prospects for the current account in 1981/82 would have been considerably better. Any permanent improvement in the balance of payments will have to rely largely on the current drive to diversify exports; efforts in this direction are already showing signs of success, but it will be some time before the full benefits are felt. In the meantime, however, it may be necessary to raise producer prices for some of the export crops. It is encouraging to note that the Ethiopian authorities are currently reviewing the structure of producer prices and that an exchange rate study is under way.

An increased level of external support on concessional terms should enable Ethiopia to support a higher level of import payments in 1981/82 and to contain the overall deficit at the 1980/81 level despite the depressed coffee prices. Even if anticipated net capital inflows in 1981/82 are realized, Ethiopia's external debt to GDP ratio will rise to only 20 per cent and the associated debt service ratio to about 7 per cent. While these ratios are not unduly high, any significant increase in the debt burden could have serious implications for an economy dependent to a large degree for its export receipts on one primary product, coffee. This reinforces the need on the part of the Ethiopian authorities to generate additional domestic savings and to accelerate their program of export diversification.

The experience so far with the program has demonstrated the authorities' strong commitment to it. Despite unfavorable external developments they have taken important steps to reduce the external and internal imbalances in the short term as well as to implement significant structural changes. The latter include a considerable reduction in subsidies and a rationalization of the indirect tax structure. Moreover, in the view of the IBRD, Ethiopia's development effort as reflected in its public investment program is realistic, operational, and satisfactory as a whole. Ethiopia may seek the support of the Fund under the extended financing facility to implement further structural changes in the economy. In the meantime, the implementation of the program for the fiscal year 1981/82 would help create conditions for sustained and balanced growth in later years and for medium-term improvement in the balance of payments. The staff considers that the policies set forth in the program supported by the stand-by arrangement are adequate to achieve its objectives. Accordingly, the following draft decision is proposed for adoption by the Executive Board:

1. Ethiopia has consulted the Fund in accordance with paragraph 24 of the Letter of Intent of April 7, 1981, annexed to the stand-by arrangement for Ethiopia (EBS/81/98, Supplement 1) in order to reach understandings with the Fund regarding policies and measures that the Government of Ethiopia will pursue during the remainder of the stand-by arrangement.

2. The letter of June 24, 1981 from the Minister of Finance and the Governor of the National Bank of Ethiopia shall be annexed to the stand-by arrangement for Ethiopia, and the letter of April 7, 1981, annexed to the arrangement for Ethiopia shall be read as supplemented by the letter of June 24, 1981.

3. Accordingly, paragraph 4(a) of the stand-by arrangement for Ethiopia is modified to read as follows:

"(a) during any period in the first two months in which the data at the end of the preceding period indicate that:

(i) the limit on total outstanding domestic credit described in paragraph 19 of the letter of April 7, 1981 and paragraph 7 of the letter of June 24, 1981 or

(ii) the limit on net credit to the Government described in paragraph 17 of the letter of April 7, 1981 and paragraph 7 of the letter of June 24, 1981

are not observed; or".

Relations with the Fund
(As of July 31, 1981)

Date of membership:	December 27, 1945
Quota:	SDR 54 million
Intervention currency and the rate:	US$; Br 1 = US$0.48309
SDR/Local currency equivalent:	SDR 1 = Br 2.3871
Direct distribution of profits from gold sales (July 1, 1976-July 31, 1980):	US$4.27 million
Distribution of gold:	23,106.991 fine ounces in four distributions
Trust Fund loan disbursements: (First and second periods)	SDR 26.38 million

Fund transactions

Fund currency holdings:	SDR 128.50 million (238.0 per cent of quota), of which SDR 54.00 million (100.0 per cent of quota) under compensatory financing
Regular facilities:	SDR 74.50 million, or 138.0 per cent of quota
SDR position:	Holdings amounted to SDR 1.85 million, or 16.6 per cent of cumulative allocation of SDR 11.16 million

Staff contacts

Last Article IV consultation:	November 4-18, 1980
Negotiation of a Stand-By Arrangement:	February 22-March 13, 1981
Stand-By Review:	June 9-25, 1981

Mr. J. de Larosière
Managing Director
International Monetary Fund
Washington, D.C. 20431

Dear Mr. de Larosière,

1. As you will recall, on May 8, 1981 the Executive Board approved a stand-by arrangement for Ethiopia in support of a financial program designed to achieve a reasonable rate of economic growth, a reduction in the overall budgetary deficit as a proportion of GDP, the elimination of two thirds of all price subsidies, and a reduction in the balance of payments deficit over the period 1980/81-1981/82. During the fiscal year 1980/81, most of the objectives of the program were achieved. For 1981/82, measures to counteract the effect of the deterioration in the external enviroment on the development effort are being taken with the hope of achieving the objectives of the program.

Review of Developments in 1980/81

2. Ethiopia's balance of payments came under severe pressure during the first half of the fiscal year 1980/81, as the export price of coffee declined sharply and import prices rose. In order to ease the strain on the balance of payments, the Government began taking measures to curtail imports and to pursue cautious demand management policies. This action resulted in a surplus of Birr 41 million in the second half of the fiscal year and the containment of the overall balance of payments deficit for the fiscal year 1980/81 to Birr 190 million, as compared with the program target of Birr 303 million. The current account deficit is estimated to have risen by Birr 217 million in 1980/81, due mainly to a sharp deterioration in the terms of trade. Despite a 4 per cent increase in coffee volume, the value of total exports fell by 13 per cent, reflecting a 34 per cent decline in coffee prices. On the other hand, imports rose by nearly 8 per cent due to sharply higher prices for petroleum products. The capital account also worsened, as net official capital inflows declined.

3. These developments adversely affected the Government's plan to increase investment and output during 1980/81. Real gross domestic output grew by 4 per cent, compared with an annual average rate of nearly 6 per cent in the preceding two years. Agricultural production rose by more than 5 per cent, mainly due to a significant expansion in output of domestic foodstuffs. However, industrial output grew by only 4 per cent, considerably less than in the previous year, which was characterized by a sharp rise in the utilization of capacity which was made possible by the improved security situation in the Administrative Region of Eritrea. Output in the building and construction sector declined in 1980/81 as a result of shortages of imported inputs. The rate of increase in domestic prices was lower than in the previous year, reflecting the larger supply of domestic food grains and improvement in the system of distribution.

4. In accordance with the objectives of the financial program, the overall budgetary deficit is estimated to have fallen from Birr 377.4 million in 1979/80, equivalent to 4.5 per cent of GDP, to Birr 330.5 million, equivalent to 3.8 per cent of GDP. Despite a 15 per cent decline in receipts from taxes on foreign trade as a result of lower value of coffee exports, total revenues are estimated to have increased by 2.3 per cent to Birr 1,606.5 million. Receipts from nontax revenues are estimated to have risen by 36 per cent, reflecting a large increase in the payment of residual surpluses and arrears from the public enterprises; receipts from domestic taxes rose by 3.8 per cent. On the other hand, total expenditure is estimated to have risen by less than 1 per cent to Birr 1,937 million. Current expenditure increased only slightly to Birr 1,569 million, as the Government sharply reduced subsidies on petroleum products and continued to restrain current expenditure on goods and services. The estimated current budget surplus of Birr 37.4 million is 41 per cent higher than originally anticipated. Capital expenditure fell by nearly 6 per cent to Birr 368 million, reflecting the scarcity of foreign exchange and the attendant shortages of imported inputs. Despite the improvement in the overall budgetary deficit, the Government borrowing from the banking system is estimated to have risen by Birr 53 million. Credit to the non-central government sectors is estimated to have increased by 9 per cent and total domestic credit by 14 per cent. Total domestic credit is expected to be within its ceiling of Birr 2,935 million at the end of June 30, 1981, and net credit to the Government is expected to be within its ceiling of Birr 1,198.8 million at the end of July 6, 1981.

Prospects and Policies in 1981/82

5. Ethiopia's economic and financial prospects for the fiscal year 1981/82 continue to be dominated by developments in the balance of payments. Although the Government plans to increase coffee production through an expansion of acreage and to expand and diversify exports, the impact of these measures on the balance of payments will be felt mainly in the medium-term. During 1981/82 the Government's efforts will be concentrated mainly on increasing the average yields of coffee production and the proportion of higher grades of coffee in total coffee exports. Measures to increase the quantity and quality of processed hides and skins will be continued. At the same time, the Government will continue its efforts to increase investment in import-substitution industries, such as processed foodstuffs, sugar, cement, and textiles, and to reduce imports of cereals by expanding production of domestic food grains. Notwithstanding the Government's efforts, the current account deficit in the balance of payments is expected to widen to Birr 745 million in 1981/82 from Birr 606 million in the previous year. The terms of trade are expected to deteriorate further as coffee export prices are forecast to fall from an average of US$1.28 per pound in 1980/81 to US$1.00 in 1981/82, and import prices to rise by 8 per cent. Moreover, despite the Government's efforts to restrain imports, because of the high import content of investment, the value of imports is forecast to

rise by 11 per cent to Birr 1,757 million while exports are estimated to rise by less than 3 per cent to Birr 875 million. The value of exports other than coffee are however expected to increase by 24 per cent. Net official capital receipts are forecast to increase sharply but are not expected to offset the current account deficit. The overall balance of payments deficit of Birr 190 million for 1981/82 is Birr 20 million higher than originally projected. We believe that this balance of payments deficit can be financed and will enable us to achieve our economic and financial objectives.

6. The budgetary prospects for 1981/82 appear to be less favorable than originally anticipated. Current revenue is estimated to increase by only 4.3 per cent to Birr 1,676 million, compared with Birr 1,782 million projected under the program. Receipts from domestic taxes are estimated to increase by nearly 18 per cent, slightly lower than originally projected; receipts from foreign trade taxes are estimated to decline by 15 per cent, nearly 16 per cent lower than projected in the program, mainly on account of lower value of coffee exports. Nontax revenues are estimated to increase slightly, but if arrears collected in 1980/81 are excluded from such revenues, the contribution of the enterprises in 1981/82 may be seen to be growing significantly. On the other hand, current expenditure in nominal terms is estimated to rise by 5.7 per cent reflecting mainly additional expenditure related to recent investment. The current surplus of Birr 18 million will be considerably lower than originally anticipated. In accordance with the Government's policy to increase investment, capital expenditure is estimated to increase sharply from Birr 368 million in 1980/81 to Birr 582 million in 1981/82. Investment in export-generating and import-substitution projects are expected to account for nearly 60 per cent of the total. The resulting overall budgetary deficit of Birr 564 million will be 70 per cent higher than in 1980/81 and more than double the amount indicated in the program. In order to finance this deficit, the Government is making efforts to obtain larger amounts of external resources. Net external borrowing is estimated to increase sharply from Birr 90 million in 1980/81 to Birr 300 million in 1981/82. Consequently, although the required domestic financing, including from nonbank sources, of Birr 264 million will be considerably higher than the Birr 139 million anticipated in the program, it will be only Birr 23 million higher than in 1980/81.

7. During fiscal year 1981/82, the objective of monetary policy will be to provide for an expansion in broad money which is consistant with the growth of real GDP, while containing price increases to the lowest realistic level possible, and meeting the credit needs of the productive sectors of the economy. On the basis of existing price policies, including the delayed impact of the recent elimination of subsidies on petroleum products, and forecasts of increases in import prices, the GDP deflator is estimated to increase by some 10 per cent in 1981/82. Considering the decline in broad money of more than 4 per cent in 1980/81 and the targeted increase in nominal GDP of 15 per cent in 1981/82, we expect broad money to increase by 18.5

per cent in 1981/82. Therefore an expansion of domestic credit by 25 per cent will be consistent with the balance of payments objective. We will ensure that total outstanding domestic credit 1/ which amounted to Birr 2,839.3 million on March 31, 1981 does not exceed Birr 3,148.0 million on September 30, 1981, Birr 3,368.0 million on December 31, 1981, Birr 3,586.0 million on March 31, 1982, and Birr 3,667.0 million on June 30, 1982. In addition, net credit expansion to the Government by the banking system will not exceed Birr 118 million on September 30, 1981, Birr 178 million on December 31, 1981, Birr 208 million on March 31, 1982, and Birr 228 million on June 30, 1982. Any net foreign budgetary borrowing in excess of the Birr 300 million anticipated for the year, and any bond sales to the Pension Commission above the level Birr 36.0 million estimated for 1981/82, will be regarded as falling within the above ceilings on net credit to the Government. It is envisaged that the total domestic credit will be adequate in relation to the projected growth of economic activity.

8. The Government believes that the policies set forth in the letter of intent dated April 7, 1981 and supplemented by this letter are adequate to achieve the objectives of the program and will take any further measures that may become necessary for the purpose. During the period of the stand-by arrangement, if these policy measures are not producing the desired results, or if unanticipated developments have arisen and corrective measures appear necessary, the Government will in consultation with the Fund take appropriate additional measures within the framework of its social and political objectives and its economic priorities to achieve the objectives of the program. Ethiopia will consult with the Fund, in accordance with the policies of the Fund on such consultations.

Yours sincerely,

/s/	/s/
Tadesse Gebre-Kidan Governor National Bank of Ethiopia	Teferra Wolde-Semait Minister of Finance

Addis Ababa
June 24, 1981

1/ Includes net credit to the Government, plus the banking system's claims on the rest of the economy, as defined in paragraph 19 of the Government's Letter of Intent dated April 7, 1981, in support of its request for a stand-by arrangement.