

**FOR
AGENDA**

EBS/82/83

CONFIDENTIAL

May 10, 1982

To: Members of the Executive Board

From: The Acting Secretary

Subject: Ethiopia - Staff Report for the 1982 Article IV Consultation
and Review of Stand-By Arrangement

Attached for consideration by the Executive Directors is the staff report for the 1982 Article IV consultation with Ethiopia and a review of the stand-by arrangement. A draft decision appears on page 18.

This subject is proposed to be scheduled for discussion on Friday, June 11, 1982.

Att: (1)

Issued in Helsinki, Finland and Washington, D.C.

INTERNATIONAL MONETARY FUND

ETHIOPIA

Staff Report for the 1982 Article IV Consultation and
Review of Stand-By Arrangement

Prepared by the Staff Representatives for the
1982 Consultation with Ethiopia

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

May 7, 1982

I. Introduction

A Fund mission visited Addis Ababa during the period February 28 - March 13, 1982 to conduct the Article IV consultation discussions and review Ethiopia's performance under the financial program which is being supported by a 14-month stand-by arrangement that ends on June 30, 1982. The Ethiopian representatives included Mr. Teferra Wolde Semait, Minister of Finance, Mr. Wollie Chekol, Minister of Foreign Trade, Mr. Tadesse Gebre-Kidan, Governor of the National Bank of Ethiopia, and other senior officials of ministries and agencies concerned with economic and financial matters. The staff team consisted of Messrs. A. Basu (head-~~AFR~~), J.P. Briffaux (~~AFR~~), C.F.J. Boonekamp (~~ETR~~), A. Feltenstein (~~FAD~~), A. Salehizadeh (~~BUR~~), and Mrs. Y. Coker (secretary-~~AFR~~).

The current stand-by arrangement provides for a total amount of SDR 67.5 million (125 per cent of quota), of which SDR 34.977 million (64.8 per cent of quota) represents ordinary resources, and it was approved by the Executive Board in May 1981 in support of a financial program covering the period January 1, 1981 to June 30, 1982. The staff paper on the last review of the stand-by arrangement, which established the performance criteria for the quarters ending September and December 1981 and March 1982, was discussed by the Executive Board in September 1981. As all performance criteria under the program were met for the quarters ending June, September, and December 1981, Ethiopia has already made purchases totaling SDR 55.75 million (103.2 per cent of quota) under the present stand-by arrangement. 1/ In addition, in May 1981 Ethiopia made a purchase of SDR 18 million under the compensatory financing facility (CFF), which, together with two earlier purchases of SDR 18 million each in July and December 1979, brought the total of such purchases to 100 per cent of quota. There are no scheduled repurchases prior to November 1982.

1/ Upon the fulfillment of the performance criteria for end-March 1982, Ethiopia would be eligible to make the final purchase of SDR 11.75 million under the current stand-by arrangement.

Ethiopia continues to avail itself of the transitional arrangements of Article XIV. A summary of the Fund's relations with Ethiopia is contained in Appendix I.

II. Background to the Current Financial Program

In Ethiopia the institutional framework and the decision-making process for economic and financial policies closely approximate those of a centrally planned economy. All financial institutions, major manufacturing enterprises, several marketing corporations for foodstuffs and exports, and large sections of urban and rural property are state-owned. In most of the agricultural sector, while the Government has ownership rights to land, individual peasant farmers have farming rights over the land they cultivate; state farms represent a relatively small segment of the whole farming sector. The peasant farmers are organized into peasants' associations, which are aided by government projects that provide inputs, credit facilities, extension services, and guidance in improved farming techniques. The Ministry of Finance and the Central Planning Supreme Council coordinate to plan and monitor all public investments, to prepare the annual budgets of the Central Government and of the state-owned entities, and to take decisions and provide guidelines for wage and price policies of the public sector.

In the two fiscal years 1978/79-1979/80 ^{1/} which preceded the current financial program, the Ethiopian economy experienced high rates of growth in real gross domestic product (GDP) and in export volume (annually averaging about 5.5 per cent and 17.5 per cent, respectively). Between 1977/78 and 1979/80 gross fixed investment as a proportion of nominal GDP rose from 7.5 per cent to 10 per cent, the external current account deficit (in goods and nonfactor services) narrowed slightly from 5.6 per cent to 5 per cent, and gross domestic savings increased from 1.9 per cent to 4.8 per cent. All this was achieved despite an overall 25 per cent deterioration in the external terms of trade during 1977/78-1979/80, which mainly reflected a drop in coffee export prices and rising import prices.

With restrained fiscal policies, the ratio of the overall fiscal deficit to GDP was reduced from 6 per cent in 1977/78 to an average of 3.8 per cent in the two years 1978/79-1979/80. Almost one half of the overall deficits were financed by recourse to net foreign borrowing, about 42 per cent by reliance on domestic bank financing, and the remainder by relatively small amounts of bond sales to the Pension Commission. Along with these fiscal policies, there was a marked deceleration in the rate of domestic credit expansion, which decreased from nearly 55 per cent in 1977/78 to an average annual rate of about 25 per cent during 1978/79-1979/80.

^{1/} Fiscal years end on July 7.

Concurrent with the above developments, the combined inflows of public transfers and capital increased markedly, and the deficits in the overall balance of payments (BOP) decreased substantially. Nevertheless, with the recurrent (albeit small) overall deficits, the banking system's net foreign assets declined from a level covering almost six months of imports (c.i.f.) in mid-1978 to a level that covered three months of imports in mid-1980. Over the first half of 1980/81 (July-December) the banking system's net foreign assets and gross official foreign reserves declined further. At end-1980 the gross official foreign reserves were equivalent to SDR 74 million, covering about six weeks of 1980/81 imports (c.i.f.).

III. Performance Under the Current Financial Program

In early 1981, when the present financial program was launched, the existing low level of foreign reserves and the prospects of another sizable deterioration in the external terms of trade presented a very difficult scenario within which to plan economic and financial policies. It was necessary to contain public investment and the imbalances in the budget and the external accounts, to levels that were consistent with the stringent financial constraints facing the economy. Given that the overall BOP deficit was already large (SDR 83 million) during the first half of 1980/81 (July to December), the financial program aimed at limiting the deficit for the fiscal year as a whole to SDR 115.4 million (3.3 per cent of GDP). More substantial external adjustment was planned for 1981/82, when the overall BOP deficit was targeted to be reduced to SDR 79.1 million (1.9 per cent of GDP) (Chart 1).

During 1980/81 Ethiopia's real GDP grew (3.3 per cent) at a slower pace than the program forecast (about 6 per cent), and real exports increased at a slower rate (8.7 per cent) than the program's projected rate (12.3 per cent) (Table 1). Agricultural harvests were adversely affected by drought and untimely rainfall in various parts of the country, and value added by the construction and services sectors expanded less than earlier forecast. The slower-than-programmed growth of real GDP was accompanied by a large deterioration in the external terms of trade during 1980/81, which resulted in an estimated income loss of roughly 3 per cent of GDP (Chart 1). Within the financial constraints that emerged in 1980/81, the ratio of investment to GDP recorded practically no increase (10.2 per cent in 1979/80), and the domestic savings ratio was higher (4.1 per cent of GDP) than the average of the preceding three years (3.4 per cent of GDP).

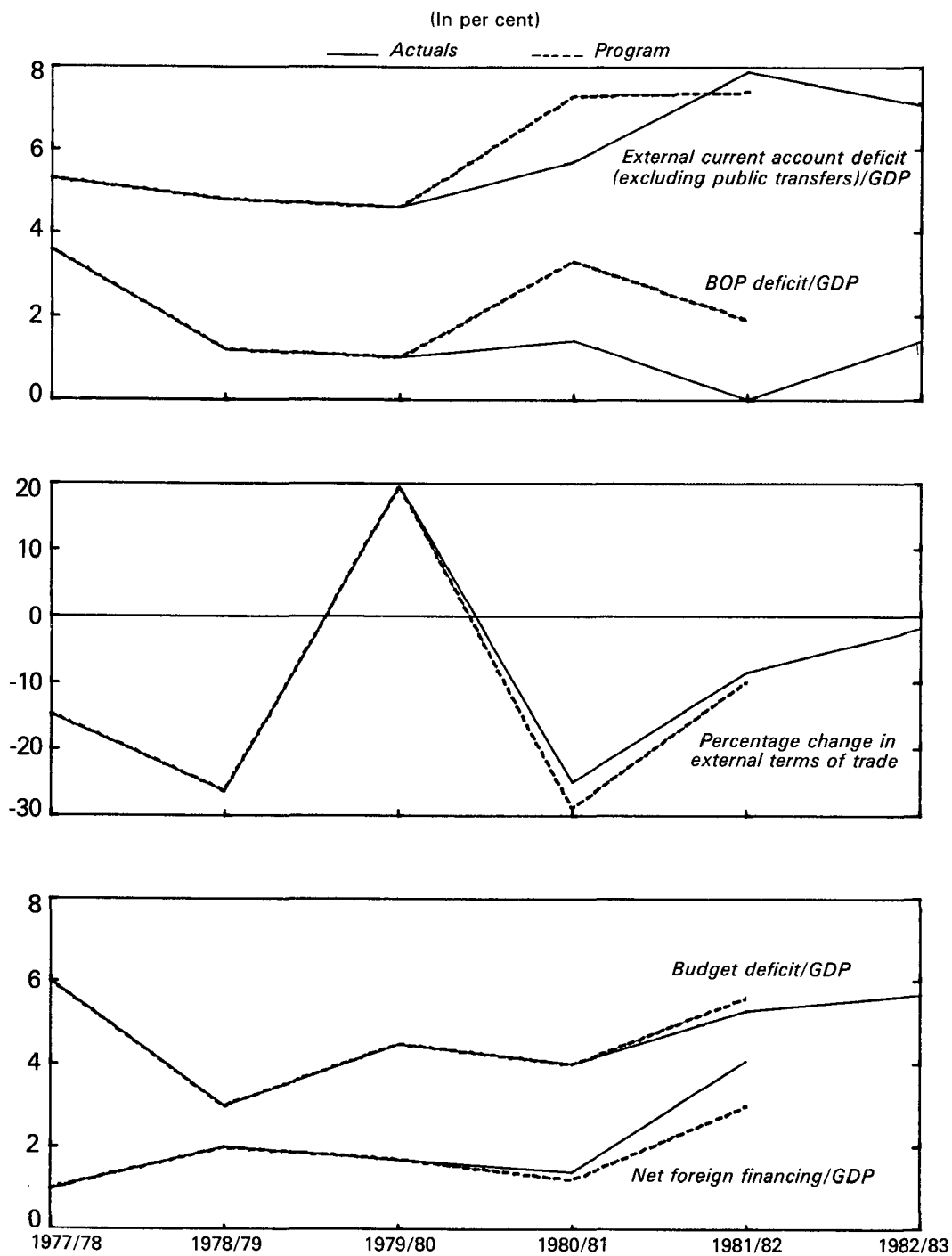
Against this background, adjustments in pricing policies, a slowdown in current budgetary expenditures, and increased revenue mobilization were relied upon to reduce the size of the overall fiscal deficit. Thus, to reduce budgetary subsidies, the domestic sales prices of petroleum products

Table 1. Ethiopia: Selected Economic and Financial Indicators,
1977/78-1981/82

	1977/78- 1979/80 (Three years prior to program)	First year (1980/81) of program		Second year (1981/82) of program	
		Original target	Actual	Original target	Revised estimates
(Annual percentage changes, unless otherwise specified)					
National income and prices					
GDP at constant factor cost	3.2	6.2	3.3	5.0	4.5
GDP deflator	4.1	4.9	1.6	6.1	1.8
Consumer prices	14.7	10.0	1.9	10.0	8.8
External sector (on the basis of U.S. dollars):					
Exports, f.o.b.	14.3	-11.5	-12.1	3.5	-0.5
Imports, c.i.f.	17.5	9.9	-0.4	9.0	19.0
Non-oil imports, c.i.f.	14.4	1.2	-1.3	8.5	17.1
Export volume	15.4	12.3	8.7	6.4	0.5
Import volume	6.9	-1.0	-7.7	0.9	10.0
Terms of trade (deterioration -)	-7.2	-29.0	-25.1	-10.0	-8.4
Nominal effective exchange rate (depreciation -)	-4.7	...	16.5	...	...
Real effective exchange rate (depreciation -)	3.7	...	9.4	...	...
Government budget					
Revenue	14.3	0.8	11.8	6.5	1.5
Total expenditure	15.5	0.2	8.2	15.4	7.9
Money and credit					
Domestic credit	34.7	12.4	8.3	24.9	6.4
of which: credit to Government	(32.6)	(23.8)	(14.4)	(19.0)	(6.6)
Money and quasi-money (M2)	12.8	-5.3	1.9	16.6	5.0
Velocity (GDP relative to M2)	4.1	4.6	3.7	4.3	3.7
Interest rate (annual rate for one year savings deposit)	6.0	6.0	6.0	6.0	6.0
(In per cent of GDP)					
Current budgetary savings	-0.3	0.3	1.0	0.2	0.1
Central government budget deficit					
Including public transfers	-4.5	-4.0	-4.0	-5.6	-5.3
Excluding transfers	-5.2	...	-5.1	...	-6.3
Domestic bank financing	2.5	2.5	1.6	2.3	0.8
Foreign financing	1.6	1.2	1.4	3.0	4.1
Gross domestic investment	8.8	10.7	10.2	11.8	12.9
Gross domestic savings	3.4	3.0	4.1	4.0	4.3
Current account deficit					
Including public transfers	-3.4	-5.8	-4.5	-5.4	-6.5
Excluding public transfers	-4.9	-7.3	-5.7	-7.4	-7.9
External debt (inclusive of use of Fund credit)	15.7	18.6	19.1	23.3	25.8
Debt service ratio <u>1/</u>	6.1	5.6	6.2	5.7	9.1
Interest payments (in per cent of exports of goods and nonfactor services) <u>1/</u>	2.7	2.6	2.9	2.5	3.7
(In millions of U.S. dollars, unless otherwise specified)					
Overall balance of payments	-70.2	-146.6	-59.0	-91.6	24.0
Gross official reserves (months of imports)	2.9	1.0	2.4	10.7	3.4
External arrears	--	--	--	--	--

^{1/} Excluding Fund charges and repurchases.

CHART 1
ETHIOPIA
SELECTED INDICATORS OF EXTERNAL AND
BUDGETARY PERFORMANCE, 1977/78-1982/83



were raised by 40-60 per cent, transport tariffs were increased, and the sales price of fertilizers was raised from Br 65/quintal in 1979/80 to Br 85/quintal in 1980/81 and to Br 116/quintal in 1981/82. In addition, other current budgetary outlays were tightly restrained, so that total current budgetary expenditure rose by 7.2 per cent in 1980/81 compared with 20.8 per cent in 1979/80. On the revenue side, export tax receipts fell by about 40 per cent due to the decrease in coffee export prices, and import tax revenues increased little, as imports remained virtually stagnant. However, tax collection procedures were strengthened to reduce tax arrears and increase public enterprises' contributions to the budget. Thus, increases in business profits tax receipts (almost 56 per cent) and in public enterprises' nontax contributions (about 105 per cent) more than offset the decline in revenues from foreign trade taxes, and total revenues were 10.8 per cent above the 1980/81 program estimate. The current budgetary surplus, though small, was three times the program estimate. Hence, although capital expenditures were about 11 per cent higher than the 1980/81 program target, the overall fiscal deficit was (about 4 per cent) smaller and equal to 4 per cent of GDP.

Somewhat more than one-third of the overall fiscal deficit was financed by reduced net foreign borrowing, and increased bond sales to the Pension Commission accounted for almost 25 per cent; the reliance on these sources of financing was larger than the corresponding program estimates. The remainder (about 40 per cent) of the deficit was covered by recourse to domestic bank financing, which was well below the margin implied by the program's credit ceilings. As envisaged under the program, budgetary bank financing was held within the program's estimate minus the initially unforeseen amounts of new net foreign borrowing and domestic bond sales. The growth of bank credit to the rest of the economy (4.7 per cent) was also much less than provided for under the program's credit ceilings for end-June 1981 (Table 2). The relatively slow expansion of credit to the nongovernment sectors was due partly to the timely repayment of domestic bank loans and partly to the tight restraints on bank lending for import financing. Reflecting these policies, the decline in the net foreign assets of the banking system (by 33 per cent) was much less than targeted under the program, broad money increased marginally (by 2 per cent), and the domestic inflation rate slowed from about 12.5 per cent in 1979/80 to around 2 per cent in 1980/81.

In 1980/81 the overall BOP deficit (1.4 per cent of GDP) and the current account deficit 1/ (5.7 per cent of GDP) were substantially lower than envisaged under the program (3.3 per cent and 7.3 per cent respectively). Although export receipts were less than earlier anticipated, entirely because of the continued decline in export prices, total import payments fell slightly and were well below the program estimate (Chart 2).

1/ Excluding public transfers.

Table 2. Ethiopia: Indicators of Performance Under the Program, 1980/81-1981/82

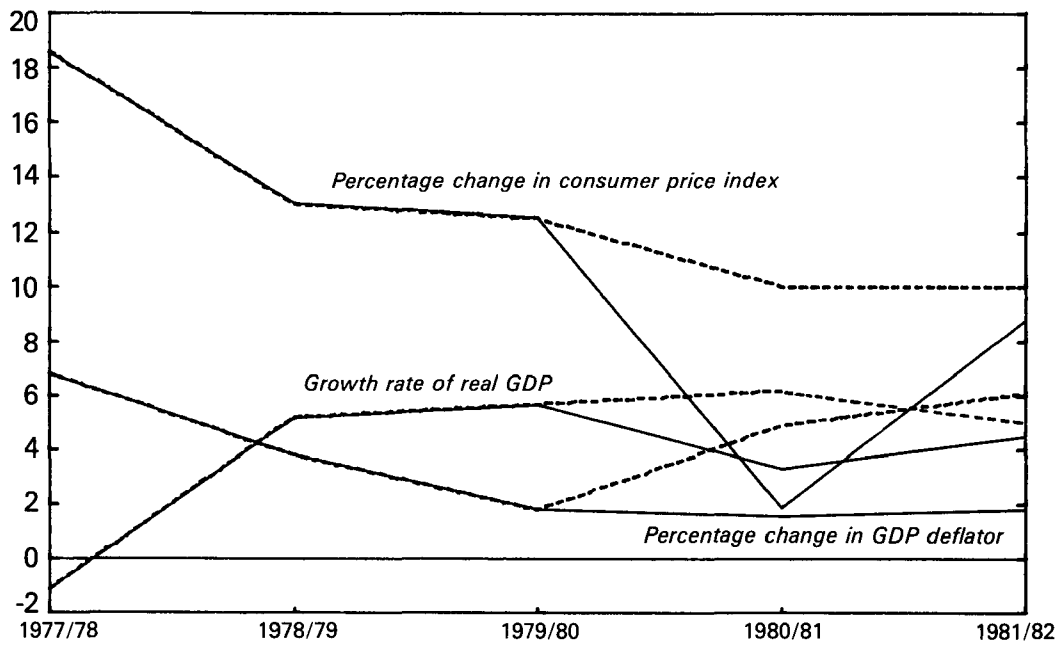
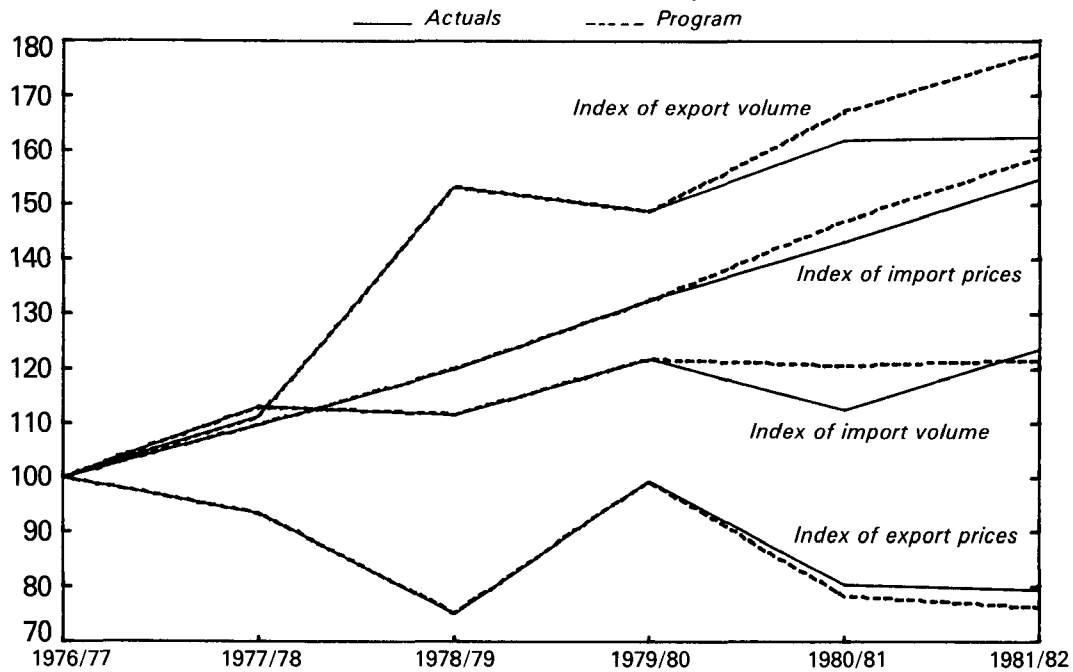
	1980/81		1981/82	
	Program	Actual	Program	Actual
<u>Nominal GDP</u>				
In millions of birr	9,195.0	8,784.7	10,102.4	9,346.4
Shortfall from program level (in per cent)	...	-4.5	...	-7.5
<u>External current account gap (excluding public transfers)</u>				
In millions of birr	672.0	500.5	744.7	736.5
Reduction from program level (in per cent)	...	-25.5	...	-1.1
Ratios to program and actual GDP	7.3	5.7	7.4	7.9
Ratios to actual GDP	7.7	5.7	8.0	7.9
<u>Overall budget deficit (including foreign grants)</u>				
In millions of birr	368.7	353.6	564.0	492.8
Reduction from program level (in per cent)	...	-4.1	...	-12.6
Ratios to program and actual GDP	4.0	4.0	5.6	5.3
Ratios to actual GDP	4.2	4.0	6.0	5.3
<u>Domestic credit (in millions of birr)</u>				
1980/81: June 1981	2,935.0	2,829.8	...	...
1981/82: September 1981	...	...	3,148.0	2,931.1
December 1981	...	...	3,368.0	2,866.8
March 1982	...	...	3,587.0	...
June 1982	...	...	3,667.0	...
<u>Net claims on Government (in millions of birr)</u>				
1980/81: June 1981 <u>1/</u>	1,198.8	1,107.9	...	...
1981/82: September 1981 <u>1/</u>	...	...	1,316.8	1,217.1
December 1981 <u>1/</u>	...	...	1,376.8	1,065.5
March 1982 <u>1/</u>	...	...	1,406.8	...
June 1982 <u>1/</u>	...	...	1,426.8	...
Change in net claims on Government	230.7	...	228.0	...
Adjusted change in net claims on Government after deducting budgetary net foreign financing and bond sales in excess of program estimates	157.1	142.0	143.9	73.5 <u>2/</u>
Budgetary net foreign financing	112.0	124.1	300.0	384.1 <u>2/</u>
Budgetary bond sales	26.0	87.5	36.0	35.0 <u>2/</u>

Sources: EBS/81/98, dated April 24, 1981, and EBS/81/176, dated August 21, 1981.

1/ Applies to end of fiscal year (July 6).

2/ Projections.

CHART 2
ETHIOPIA
INDICATORS OF PRICES,
FOREIGN TRADE, AND REAL GDP, 1976/77-1981/82



There was no change or tightening in the restrictive system. While the payments for petroleum grew by only 2.5 per cent and for capital goods by 7.8 per cent, all remaining imports declined substantially, primarily because of the tighter credit policies and the emphasis put on reducing existing stocks of imported goods. The trade deficit was thus much smaller than programed. Mainly due to this, both the current account gap and the overall BOP deficit were much smaller than programed. Indeed, during the second half of 1980/81 the banking system's net foreign assets recovered slightly to a level that covered about one month of 1980/81 imports (c.i.f.).

In 1981/82 the prospects for a partial recovery in the growth rate of real GDP (to 4.5 per cent) are fairly strong. With improved weather conditions, agricultural output is expected to rise more rapidly than in 1980/81. As a result of the completion of ongoing industrial projects, the growth rate of manufacturing output is expected to accelerate. However, overall export volume is forecast to remain virtually stagnant, and the external terms of trade are forecast to decline further by 8.4 per cent.

In 1981/82 the overall fiscal deficit (about 5.3 per cent of GDP) is expected to be contained below the program estimate (5.6 per cent of GDP). During the first half of 1981/82 (July-December 1981), the current budget recorded a larger surplus than the program's target for the whole year, and capital expenditures and the overall fiscal deficit were both less than half the corresponding estimates for the full fiscal year. During this period budgetary net foreign borrowing exceeded the program's assumption for the fiscal year by 20.8 per cent. With this the Government financed its fiscal deficit and also reduced its net indebtedness to the banking system by a substantial margin. In addition, as credit to the rest of the economy increased only moderately, the actual levels of outstanding bank credit to the Government and to the economy as whole were well below the corresponding program ceilings for September and December 1981. After accounting for these developments, during 1981/82 bank credit to Government is expected to increase by 6.6 per cent and to the economy as a whole by 6.4 per cent, which would leave the levels of outstanding bank credit at some 17-18 per cent below the program's corresponding ceilings for end-June 1982.

Compared to the program's estimates, in 1981/82 the external current account gap 1/ is expected to be slightly less, but its ratio to GDP (7.9 per cent) would be slightly higher. 2/ With prospects of a small decline in exports and a continued increase in import prices, it became clear that the only way a much-needed increase in import volume could be

1/ Excluding public transfers.

2/ The latter is entirely due to the fact that the revised 1981/82 projection for GDP is some 7.5 per cent below the program's initial assumption for GDP (Table 2).

financed without a serious depletion of net foreign assets was by making new efforts to mobilize a larger amount of official foreign grants and capital than in the previous fiscal year. Thus, the 1981/82 BOP forecasts include both an expected modest increase in net inflows of public transfers of Br 20 million, to Br 128 million, and a large (almost three-fold) increase in net foreign borrowing to Br 620 million. Approximately 60 per cent of the latter was already mobilized during the first half of the fiscal year, and the authorities felt that there are good prospects for mobilizing the remainder from the existing pipeline of undisbursed loan commitments. Based on these forecasts, the overall BOP is expected to show a small surplus of SDR 21 million instead of the programed deficit of SDR 79.1 million. This outcome would help maintain the banking system's net foreign assets at a level that continues to cover about two months of imports (c.i.f.) for 1981/82. 1/

Ethiopia's outstanding (disbursed) external public debt is projected to reach SDR 1.0 billion (23.3 per cent of GDP) by July 7, 1982, which is more than double the level (SDR 0.4 billion, or 14.2 per cent of GDP) on July 7, 1978. As foreign loans continue to be contracted on concessional terms, the related debt service burden is forecast to remain moderate, although rising from an average of 6.0 per cent of exports (of goods and nonfactor services) during 1977/78-1980/81 to 9.1 per cent in 1981/82.

The exchange rate for the birr continues to be pegged to the U.S. dollar at Br 2.07 per U.S. dollar. Between January 1975 2/ and February 1982, the birr has effectively appreciated by about 10 per cent in terms of a trade-weighted basket of foreign currencies. In real terms, the effective exchange rate has appreciated by about 33 per cent on a trade-weighted basis.

IV. Report on Discussions of Policy Issues

Ethiopia's investment requirements and related resource needs are set out in the preliminary outline of a Ten-Year Development Plan 3/ for the period 1980/81-1989/90. Of the plan's total investment of Br 27.7 million, about 38.5 per cent is targeted for the first five years, which entails an increase in the annual investment effort from Br 0.9 billion

1/ During the first six months of 1981/82 the net foreign assts of the banking system rose by some SDR 40.4 million, as compared with the presently targeted increase of SDR 21.0 million for the whole year.

2/ The overall BOP recorded small surpluses during 1974/75-1976/77 and the current account was in virtual equilibrium during 1974/75.

3/ The plan's outline is contained in the document "Ten-Year Investment Programme 1980/81-1989/90," which was presented at the country review meetings of the 1981 U.N. Conference on the Least Developed Countries.

(10 per cent of GDP) in 1979/80 to Br 2.9 billion (24 per cent of GDP) by 1984/85. Such an expansion in the investment effort would require a substantial rise in the domestic savings/GDP ratio (about 5 per cent in 1979/80), if the external current account deficits and the associated foreign borrowing are to be limited to levels that are consistent with maintaining a manageable debt service burden.

Preliminary forecasts of the financial imbalances in prospect for 1982/83 suggest an overall fiscal deficit of Br 595 million (5.7 per cent of GDP), 1/ compared with Br 493 million (5.3 per cent of GDP) for 1981/82, and an external current deficit (excluding public transfers) of SDR 322 million (7 per cent of GDP) 1/ as against SDR 312 million (7.9 per cent of GDP) in 1981/82. 2/ In view of the anticipated financial imbalances, the discussions focused on the economic and financial policies to be followed, especially those affecting domestic production and exports, the financial management of public enterprises, budgetary performance, domestic financial savings mobilization, and external debt management.

1. Economic policies

The expansion of export volume that accompanied the growth of real GDP during 1978/79-1980/81 would need to be continued in the years ahead. However, according to preliminary forecasts, export volume is expected to show little growth during 1981/82 and 1982/83, and growth in later years would depend on the implementation of appropriate policies to promote both coffee and non-coffee exports.

In the coffee sector, where private farmers produce most of the output, the main impediments to increasing production are inadequacies in cultivation techniques, the prevalence of coffee-berry disease, and relatively low producer prices compared with sales prices in the unofficial domestic market. With the decline in world coffee prices and the effective appreciation of the birr in real terms, coffee producer prices have also declined in real terms. To counter these problems various steps have been taken and others are being studied for possible implementation. With financial assistance from the European Economic Community (EEC), extension services are being expanded and improved in the country's coffee growing regions. A widespread spraying program is in operation to eradicate coffee berry disease, which still affects about one fifth of the crop. A disease-resistant variety of coffee has been developed recently and is being used for new plantings on the state farms. A project for the rejuvenation of coffee plantations is also under consideration. Owing to the higher price it fetches on the world market, emphasis is being given to increasing the exports of washed coffee. Existing washing capacity is about 16,000 tons

1/ Assuming a nominal GDP increase of about 12 per cent in 1982/83.

2/ Appendix II shows these basic data.

per annum (roughly 18 per cent of coffee exports), and 50 per cent of this capacity remained unutilized in 1980/81. As the premium paid locally to producers for washed coffee was raised in 1981/82 from Br 1,000 per ton to Br 1,146 per ton, an additional 3-4 thousand tons of washed coffee is expected to be produced this year. A project for the further expansion of coffee washing capacity has been prepared and is being discussed with the IBRD. ^{1/} Finally, serious consideration is being given to various policy proposals that would enable coffee producer prices to be raised to a more remunerative level and help to strengthen official marketing efforts.

As regards non-coffee exports, efforts are being made to increase the exportable outputs of several products, including pulses, oilseeds, cotton, fruits and vegetables, leather goods, and meat and other livestock products. To generate exportable surpluses, efforts are under way to promote cash crop cultivation and technological improvements in cultivation practices in the predominantly peasant farming sector, where most farmers still use traditional farming practices to produce chiefly for subsistence consumption. The formation of cooperatives on a voluntary basis is being encouraged, so that it becomes easier both to provide the farming sector with credit facilities, inputs, extension services, and guidance on better farming methods and to integrate it with commercial marketing and distribution channels. A major vehicle of the Government's agricultural development policy in the peasant sector is the World Bank supported Minimum Package Programme, which aims at increasing production through the provision of inputs, credit facilities, and extension services. On the state farms, too, the output of industrial and cash crops (such as cotton, fruits and vegetables, and coffee) is to be expanded, both for meeting domestic consumption needs and for export. Projects for cultivating high-value cash crops in irrigated valleys are also in an advanced stage of preparation.

In the case of processed and semiprocessed products such as hides and skins, leather goods, and meat and other livestock products, the problems facing exports are due both to the inadequate quality of some of the products and to the difficulties of penetrating foreign markets. To counter these problems, increased emphasis is being given to producing semiprocessed hides and skins which are of internationally competitive quality and are in relatively high demand. For the perishable products, refrigeration and adequate packaging facilities are being set up near ports and airports to ensure a high quality standard of these exports. Moreover, a livestock development program is also expected to be implemented, with the objectives of controlling livestock diseases and of developing an integrated system of services, production, and marketing for the improvement of breeding and the expansion of exports.

^{1/} A summary of IBRD/IDA lending operations is contained in Appendix III.

Greater import substitution is also expected to be achieved with increases in agricultural production (especially of cereals) and with the expansion of the manufacturing sector. Planned investments in manufacturing are geared to increasing the domestic production of basic consumer goods (such as processed cereal products, edible oils, sugar, textiles, shoes, and leather goods) and of intermediate and capital goods (such as fertilizers, cement and building materials, and agricultural machinery). Investments in mining will be for the development and exploitation of minerals such as potash and copper; a project for the exploration of oil (in the Ogaden region) is being launched. In the energy sector, investment projects will also be geared to developing hydroelectric and geothermal sources of power (to substitute for imported fuel) and to expanding the existing network of electricity distribution.

In recent years some entities in the public sector, namely, the state farms and certain public enterprises, have experienced financial difficulties because of relatively high debt/equity ratios and because unit production costs are not covered by sales prices. On the state farms steps have been taken to slow the further expansion of acreage, improve productivity and management of existing resources (land, capital equipment, and labor), and cultivate high value industrial and cash crops (such as cotton, coffee, and fruits and vegetables), all of which would enable this sector to become financially stronger. The state farm sector's burden of overdue domestic bank debt and related service payments has also been rescheduled recently to more manageable levels. The Government will be studying the relatively high debt/equity ratios of the state farms and of certain public enterprises (in the construction, transportation, pharmaceuticals, and leather goods sectors) on a case-by-case basis, to provide these entities, if necessary, with an expanded capital base. This policy is expected to reduce their borrowing needs to levels which would not entail an unduly heavy burden of domestic debt service payments.

Public enterprises as a whole have remained profitable, and their total budgetary contributions have grown as a proportion of budgetary receipts from 20 per cent in 1979/80 to nearly 30 per cent in 1981/82. The mission stressed the importance of continuing to improve the financial position and profitability of the public enterprises with a view to achieving further expansion of the tax base and budgetary revenues. The Ethiopian representatives agreed with this and indicated that the Government will be following appropriate policies of wage restraint and price flexibility. According to the official guideline, wage increases for workers, including all those earning less than Br 600/month in the government services and less than Br 650/month in the public enterprises, are to be limited to a maximum of 7 per cent. In principle, this maximum increase comprises a reward of 5 per cent for increasing production and of 1 per cent each for improvements in productivity and profitability, but its apportionment among wage earners is subject to labor-management negotiation at the level of each enterprise. The authorities remain

committed to a policy of avoiding the maintenance of price subsidies on a permanent basis. In deciding cases for price adjustment, due consideration will continue to be given to reducing unit production costs through improvement in productivity and saving on cost elements, so that the needed price adjustment may be less severe. Nevertheless, consideration is currently being given to adjusting selected prices and tariffs, namely, those of edible oils and electricity. The former is necessary because of past increases in the farm gate prices of oilseeds and the latter because the last increase in the price of petroleum products has raised the costs of electricity generation based on diesel fuel.

2. Financial policies

During the 1980s strong efforts will be needed to mobilize domestic resources for increasing public investment, which represents about 85 per cent of the plan's total investment projection. Hence, to generate larger current budgetary savings in the years ahead, the authorities will be relying on both tax measures and appropriate restraints on current expenditures (mainly in areas other than essential maintenance outlays).

The Government is presently considering proposals for a reform of the indirect tax system, with a view to both simplifying these taxes and adjusting selected tax rates. The latter includes the conversion of some specific taxes to ad valorem rates and the raising of certain tax rates to offset the revenue lost from the abolition of certain other taxes. This reform is expected to be implemented in 1982/83. The authorities are also giving consideration to reducing the one-year lag in the assessment of profits taxes and to improving the assessment of rural income taxes. In the area of foreign trade taxes, they are actively examining proposals for appropriate adjustments in coffee export taxes, in conjunction with investment, marketing, and exchange policies, which would have the potential of strengthening producers' incentives and of increasing both coffee exports and related tax receipts. As the revenue measures for the 1982/83 budget were not finalized at the time of the consultation discussions, the 1982/83 revenue projection includes a preliminary estimate of 7.4 per cent revenue growth without accounting for all possible new revenue measures.

The preliminary budgetary forecasts for 1982/83 include an estimated 7-8 per cent growth in current outlays and a small current surplus. The authorities feel that, with an early settlement of the internal political conflict in the Eritrea region, and with new tax measures, a much larger current budgetary surplus could be generated for financing planned capital outlays. As in earlier years the estimated capital outlays, which are about 20 per cent above the 1981/82 level, are predicated on the availability of project-related foreign financing and on maintaining a reasonable proportion between domestic bank financing and budgetary revenues. To achieve the latter, the authorities will be making every effort to raise the current budgetary surplus above its presently estimated level and mobilize more resources through noninflationary domestic borrowing (mainly through bond sales).

The authorities intend to continue to monitor increases in domestic bank credit strictly, to ensure that the overall expansion is constrained to meet appropriate balance of payments objectives and to avoid excessive monetary expansion. To facilitate this, and to provide an adequate margin for credit expansion to the nongovernment sectors, due consideration will continue to be given to limiting the overall fiscal deficit and its bank financing component. In expanding credit to the nongovernment sectors, the authorities will continue to emphasize timely repayments of outstanding bank loans and the financing of productive activities. The authorities pointed out that, by pursuing these policies, they have been able both to keep well within the program's credit ceilings for the Government and the economy as a whole and to ensure the achievement of the program's balance of payments objectives.

As regards interest rate policy, the nominal rates remain fixed. Although in recent years deposit and lending rates have been generally negative in real terms, with the drop in the domestic inflation rate (to 2 per cent) in 1980/81 both deposit and lending rates were positive in real terms. Nevertheless, the mission pointed out that at present the main long-term lending institution, the Agricultural and Industrial Development Bank (AIDB), has no domestic deposit base and relies entirely on central bank financing and on the Treasury's on-lending of foreign loans to finance its credit operations, which are extended largely for agricultural and industrial activities. In view of the increasingly important role that the AIDB is expected to play in financing both working capital and investment in the productive sectors, the authorities indicated that they are presently considering proposals for increasing the AIDB's resources, including the issuance of new savings instruments with attractive interest rates. More generally, in view of the substantially increased need for domestic resource mobilization under the 1980/81-1989/90 Plan, the mission argued in favor of an increase in interest rates. Based on an analysis of recent preliminary data on the commercial bank's balance sheet and income statement, the mission indicated that, even with a fairly sizable shift in the structure of its deposits toward quasi-monetary deposits, moderately higher deposit and lending rates were not likely to cause a deterioration in its gross profits situation. Moreover, as domestic debt service payments represented a relatively small fraction of most public enterprises' costs and sales turnover, a moderate increase in interest rates would generate very minimal cost-push inflationary pressures. In these circumstances, the authorities agreed to study the case for higher interest rates.

3. External prospects and policies

The preliminary BOP forecasts for 1982/83 indicate prospects of a decline in the ratio of the current account gap to GDP (from 7.9 per cent to 7 per cent), a drop in the combined net inflows of official transfers and capital (by about 23 per cent from the relatively high 1981/82 level), and a renewed decline in the banking system's net foreign assets (equal to roughly 1.4 per cent of GDP compared with a small overall surplus in 1981/82). Export receipts are expected to grow somewhat faster (8.3 per

cent) than import payments (5.2 per cent). The external terms of trade are projected to show a slight deterioration, the volume of exports a small increase, and real imports a slight decline. In the longer term the country's investment needs for the 1980s will require a more rapid growth of imports, which, with the slow export growth prospects under existing exchange policies, could lead to a widening of the external current account gap. Such a development, in the absence of substantially increased amounts of foreign assistance, could result in an unduly heavy attrition of existing foreign reserves.

The Ethiopian representatives agreed that, in the future, the deficits in the external current account could be both larger and sustainable, only if their expectations about mobilizing larger amounts of concessional foreign assistance than the generally low levels of the past several years were realised. Therefore, the targets for the external current account deficits under the annual investment programs should continue to reflect both the amount of foreign resources that can be mobilized without creating debt service problems and the need to avoid serious pressures on the foreign reserve position.

Since the current account deficits are predicated upon these factors, the margin for expansion of necessary imports would depend importantly upon the rate at which exports can be increased. Hence, the mission emphasized that due consideration should be given to continued implementation of a investment, price, and exchange policies, that are consistent with maintaining sustainable current account gap and improving domestic supply conditions.

With regard to the mobilization of foreign resources, the key issues relate to the management of the overall external debt situation, the purposes for which foreign loans are to be used, and the prospects for inflows of direct investment. As in past years, the authorities intend to mobilize foreign loans on concessional terms with a view to avoiding an unmanageable burden of external debt service payments. In this respect, they indicated that they would monitor the amounts and terms of foreign borrowing closely so as to contain the related service payments within a range of 8-10 per cent of exports. ^{1/} As regards the use to be made of foreign loans, they stated that this would generally be for increasing the productive potential of the economy, mainly through projects that have sound prospects of generating a net saving in terms of foreign exchange. They felt that these policies would enable them to continue to maintain a manageable external debt situation. Finally, to encourage foreign investment in the form of joint ventures, an appropriate investment code with adequate provisions for profit repatriation is presently being prepared. The authorities also intend to continue to negotiate the settlement of all outstanding compensation claims of nationalized foreign firms.

^{1/} This ratio excludes prospective Fund charges and repurchases.

In addition to using reasonable estimates of potentially available foreign resources in planning future deficits in the external current account, the authorities will also take into consideration the need to maintain an adequate level of foreign reserves. In this respect, they indicated that it was their objective to maintain the banking system's net foreign assets at a level that provides cover for about three months of annual imports.

The Ethiopian representatives indicated that no new exchange and trade restrictions had been introduced since the last consultation discussions. They further indicated that they intend to relax the present restrictions as soon as circumstances permit. The current restrictions were introduced in 1978 when Ethiopia was faced with rapidly declining reserves. In early 1978, the granting of foreign exchange was denied for the importation of some foodstuffs, alcoholic beverages, and other consumer goods. In mid-1978 the National Bank began granting foreign exchange licenses for only essential or scarce goods. Since then some relaxation of restrictions has been introduced in practice to permit the importation of certain items, such as basic consumer goods. While care is taken to discourage the importation of a commodity when existing stocks in the country are adequate, the Ethiopian authorities continue to administer the restrictive system in a flexible manner to meet the country's essential import needs. Ethiopia currently does not have any bilateral payments arrangements.

V. Staff Appraisal

Over the three fiscal years 1978/79-1980/81 Ethiopia's real GDP and overall export volume grew rapidly (annually about 5 per cent and 15 per cent, respectively). With the expansion of public investment, the ratio of total investment to GDP rose from 7.5 per cent in 1977/78 to 10.2 per cent in 1980/81. However, since the growth of production was accompanied by a marked decline in the external terms of trade, the domestic savings ratio rose from less than 2 per cent in 1977/78 to only 4.1 per cent in 1980/81. The ratio of the overall fiscal deficit to GDP averaged about 4 per cent annually during 1978/79-1980/81 as against 6 per cent in 1977/78, while the external current account gap (excluding public transfers) increased slightly from 5.3 per cent to 5.7 per cent of GDP. Domestic credit expansion slowed, and recourse to foreign financing increased substantially. The country's outstanding disbursed external debt increased as a proportion of GDP (to about 19 per cent), but, with foreign assistance being mobilized on concessional terms, debt service payments remained a manageable proportion of exports, ranging between 5-8 per cent. As the balance of payments was in persistent deficit up to 1980/81, the banking system's net foreign assets declined from the equivalent of roughly six months of imports at mid-1978 to about two months of imports at mid-1981.

The current financial program, which was launched in the middle of 1980/81 (January 1981), aimed primarily at restoring a more viable balance of payments position by limiting the overall fiscal deficit and the public investment effort to the prevailing domestic and external resource constraints. The implementation of the program has been carried out in a manner consistent with the program's performance criteria and balance of payments objectives. The overall fiscal deficit for 1980/81 and that projected for 1981/82 are smaller than the program's estimates. Domestic credit expansion to the Government and to the economy as a whole have slowed and have been restrained to well within the margins provided under the program's credit ceilings. During the period important adjustments were made in official price policies to phase out related price subsidy payments. The ratios of the external current account gap to GDP for 1980/81 and 1981/82 are consistent with those targeted under the program, and the overall balance of payments position in these years appears more favorable than was envisaged under the program.

For the public sector to be able to undertake the planned rapid expansion of investment in the coming years, it will be necessary to strengthen the financial situation of some public enterprises, increase domestic savings, and mobilize additional foreign assistance. The staff feels that the authorities' adherence to policies of periodically adjusting officially controlled prices, and of determining wage increases with reference to increments in production, productivity, and profitability, are appropriate for ensuring the self-sustaining position of the public enterprise sector. Also, as envisaged by the authorities, it would be important to take steps to strengthen the capital base of the public enterprises that are experiencing financial strains due to their high debt/equity ratios. The staff feels that an improvement in the financial position and the profitability of the public enterprises and of the export sector could contribute importantly to an expansion of related tax bases and hence budgetary revenues. The process of domestic resource mobilization could also be strengthened, if the state-owned banks were to implement appropriate adjustments in domestic interest rates and issue more attractive savings instruments. This policy, along with more realistic exchange policies, would provide a more appropriate framework of cost-price relationships for the production of import substitutes and exportable goods, and for making rational investment decisions in the present environment of scarce financial resources (domestic and external). They would also contribute to improving the long-term prospects for both overall growth and export expansion.

In addition to resource allocation policies such as those affecting cost-price relationships and direct sectoral public investment decisions, the authorities will need to continue to implement sound demand-management policies. To the extent that early action is taken on presently contemplated tax measures and progress is made to resolve the security problems in the Eritrea region, the task of containing the relative size of future

fiscal deficits to GDP would be easier. It is encouraging to note that in the years ahead the authorities intend to limit the overall fiscal deficits and the public investment effort to foreseeable financial constraints, with a view to keeping the foreign debt situation manageable and domestic bank financing of the budget within relatively moderate proportions of budgetary revenues. To achieve this, it would be important to restrain public expenditures to levels that reflect actual inflows of concessional foreign assistance and increased amounts of noninflationary domestic financing. In addition, the authorities will need to carry out their intention to continue to restrain overall domestic bank credit expansion in a manner that is consistent with avoiding serious pressures on the country's foreign reserve position and the domestic price level.

The restrictions on current payments that were introduced in 1978 at a time of rapidly declining reserves remain in force. Since then Ethiopia has not introduced any new exchange restrictions. Since mid-1979 there has been a de facto easing of controls on essential imports. The authorities intend to relax existing restrictions further as the balance of payments position improves. The staff recommends approval of the restrictions on current payments until the completion of the next Article IV consultation or May 31, 1983, whichever is earlier.

VI. Proposed Decision

The following draft decision is proposed for adoption by the Executive Board:

1. The Fund takes this decision relating to Ethiopia's exchange measures subject to Article VIII, Section 2, and in concluding the 1982 Article XIV consultation with Ethiopia conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance Over Exchange Rate Policies).

2. Ethiopia continues to maintain restrictions on payments and transfers for most current international transactions, as described in the paper on recent economic developments.

The Fund notes the intention of the authorities to relax the existing restrictions further as circumstances permit. In the meantime, the Fund grants approval for the retention of the exchange restrictions subject to Article VIII, Section 2 until the completion of the next Article IV consultation or May 31, 1983, whichever is earlier.

Relations with the Fund
(As of March 31, 1982)

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 2.3047
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:	SDR 26.38 million

Fund transactions

Fund currency holdings:	SDR 163.75 million (303.2 per cent of quota), of which SDR 54.00 million (100.0 per cent of quota) under compen- satory financing
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SDR position:	Holdings of SDR 3.43 million (30.7 per cent of net cumula- tive allocation of SDR 11.16 million)
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Staff contacts

Last Article IV consultation:	November 4-18, 1980
First stand-by review:	June 9-25, 1981

ETHIOPIA--Basic Data

Area, population, and GDP per capita

Area:	1.2 million square kilometers
Population:	
Total (mid-1982 estimate)	33.5 million
Growth rate	2.3 per cent
GDP per capita (1982):	SDR 118 (Br 279)

<u>1978/79</u>	<u>1979/80</u>	<u>1980/81</u>	<u>1981/82</u>	<u>1/1982/83</u>	<u>1/</u>
<u>Fiscal year ended July 6</u>					

Gross domestic product (GDP)

(In millions of birr)

GDP at current market prices	7,967.2	8,462.2	8,784.7	9,346.4	10,468.0
Agriculture (per cent of total)	44.1	44.0	44.1	43.4	...
Manufacturing (per cent of total)	5.9	6.3	6.6	6.6	...
Distribution services (per cent of total)	13.5	13.8	14.2	14.1	...
GDP at constant 1960/61 factor cost	4,217.5	4,456.2	4,603.9	4,811.0	5,052.0

Government finance

Revenues and cash grants	1,375.2	1,559.9	1,743.3	1,769.0	1,900.0
Expenditure	1,614.8	1,937.3	2,096.9	2,261.8	2,494.9
Current	(1,281.9)	(1,548.0)	(1,658.7)	(1,763.0)	(1,894.9)
Capital	(332.9)	(389.3)	(438.2)	(498.8)	(600.0)
Overall deficit and financing	239.6	377.4	353.6	492.8	594.9
External borrowing (net)	(161.1)	(142.5)	(124.1)	(384.3)	(...)
Domestic financing (net)	(78.5)	(234.9)	(229.5)	(108.5)	(...)

1/ Planned or budgeted.

ETHIOPIA--Basic Data (continued)

	<u>1979</u>	<u>1980</u>	<u>1981</u>	<u>1982 1/</u>	<u>1983 1/</u>
	<u>End of June</u>				
<u>Money and credit</u>	<u>(In millions of birr)</u>				
Domestic credit	2,085.0	2,612.3	2,829.7	3,011.4	...
Claims on Government (net)	(862.3)	(968.1)	(1,107.9)	(1,181.4)	(...)
Other credit	(1,222.7)	(1,644.2)	(1,721.8)	(1,830.0)	(...)
Money and quasi-money	1,859.3	2,332.2	2,377.6	2,496.5	...
	<u>1978/79</u>	<u>1979/80</u>	<u>1980/81</u>	<u>1981/82 1/</u>	<u>1982/83 1/</u>
	<u>Fiscal year ended July 6</u>				
<u>Balance of payments</u>	<u>(In millions of SDRs)</u>				
Exports, f.o.b.	280.8	364.5	322.6	352.2	385.9
Of which: coffee	(204.1)	(234.5)	(201.4)	(215.1)	(221.7)
Imports, c.i.f.	459.5	545.1	562.0	734.3	780.8
Trade balance	<u>-178.7</u>	<u>-180.6</u>	<u>-239.4</u>	<u>-382.1</u>	<u>-394.9</u>
Services (net)	16.4	21.0	27.5	37.3	42.6
Private unrequited transfers	18.2	15.4	19.6	33.7	36.2
Current account balance	<u>-144.1</u>	<u>-144.2</u>	<u>-192.3</u>	<u>-311.1</u>	<u>-316.1</u>
Official unrequited transfers	46.6	46.0	41.5	54.0	81.0
Capital account (net)	42.2	62.9	84.7	277.6	170.6
Errors and omissions	16.0	1.5	15.3	--	--
SDR allocations	3.6	3.7	3.8	--	--
Overall balance (deficit -)	<u>-35.7</u>	<u>-30.1</u>	<u>-47.0</u>	<u>20.5</u>	<u>-64.5</u>
<u>Exchange rate (Br/SDR, period average)</u>	2.6531	2.6934	2.6030	2.3707	2.3451

1/ Staff projections.

ETHIOPIA--Basic Data (concluded)

	<u>1978/79</u>	<u>1979/80</u>	<u>1980/81</u>	<u>1981/82</u>	<u>1/ 1982/83</u>	<u>1/</u>
	<u>(In millions of SDRs)</u>					
<u>External public debt</u> <u>(end of period)</u>						
Disbursed and out- standing	453.9	516.7	625.2	901.1	1,114.3	
Debt service payments (including Fund charges and repurchases)	21.7	23.7	27.7	46.8	64.0	
	<u>1979</u>	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>	
<u>Gross official interna- tional reserves</u> <u>(end of June)</u>	84.9	117.9	124.7	213.0	...	
				<u>Feb.</u>		

1/ Staff projections.

Ethiopia: Summary of IBRD/IDA Lending Operations,
1980/81-1981/82

(In millions of U.S. dollars)

	1980/81	1981/82 <u>1/</u>
IDA lending program	<u>75.0</u>	<u>90.0</u>
Agriculture and rural development	40.0	60.0
Minimum Package Project II	(40.0)	(--)
Coffee Processing II	(--)	(60.0)
Education V	35.0	--
Industry: Technical Assistance DFC IV	--	30.0
IBRD/IDA gross disbursements	33.4	33.0
Less: amortization	4.3	6.9
Equals: net disbursements	29.1	26.1
Less: interest and charges	6.9	6.9
Equals: net transfer	22.2	19.2

Source: IBRD.

1/ Presently under negotiation.