

Introduction

The Federal Democratic Republic of Ethiopia is located in the Horn of Africa. It shares borders with Eritrea to the north and northeast, Djibouti and Somalia to the east, Sudan and South Sudan to the west, and Kenya to the south. The country has an area size of roughly 1,126,829 square kilometer, making it the 10th largest country in the continent. With a population of 102 million inhabitants, Ethiopia is the second-most populous nation in Africa after Nigeria. Like most countries in the region several different languages are spoken in Ethiopia. While all languages enjoy equal state recognition in the Constitution, Amharic is the official working language of the Federal Government. English is the most widely spoken foreign language.

The services, agricultural and mining industry are key sectors for Ethiopia's economy. While coffee, oil seeds, legumes, gold, and cut flowers have traditionally been the main sources of foreign reserves, the growth of light manufacturing industries, especially in the textiles and leather sectors is enabling the country to diversify its sources of growth and trade. The sustained investment and modernization of infrastructure accompanying that process of transformation has positioned Ethiopia as one of the fastest growing countries in the world over the last decade.

Political Environment

The Ethiopian Peoples' Revolutionary Democratic Front (EPRDF) which was established in May 1991 emerged as the ruling party after seventeen years of armed insurrection against a Marxist military government known as the Derg. The EPRDF coalition established a federally organized state, and in 1994 adopted a new constitution establishing a parliamentary republic with a bicameral legislature and a judicial system. The EPRDF won the first multiparty election which took place in May 1995 and has remained in power since. The EPRDF supports broad-based modernization intended

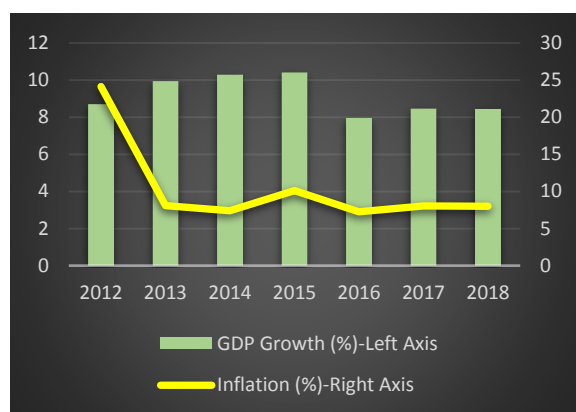
to transform Ethiopia from a poor, rural, agricultural state to a middle income, urban, and industrialized economy by 2025.

Following the death of Meles Zenawi, the first leader of the EPRDF, Hailemariam Desalegn assumed office as Prime Minister in 2012 and remained in office following the EPRDF victory in the 2015 elections. He announced his resignation in February 2018 amid nationwide protests. Abiy Ahmed who emerged as the new leader of Ethiopia's ruling coalition was sworn in as Prime Minister on the 2nd of April, 2018. Ethiopia's next legislative election is scheduled for 2020.

Economic Overview

GDP: Ethiopia's economy has experienced strong, broad-based growth. With GDP growth averaging around 10% over the last decade, compared to a regional average of 5.4%, Ethiopia has been the fastest growing country in the continent. Growth has been driven by public investments in agriculture and infrastructure as well as expansion of the services and manufacturing sectors. Higher economic growth brought with it positive trends in poverty reduction in both urban and rural areas. The poverty rate fell from 44 percent in 2000 to 23.5 percent in 2015/16. GDP growth in 2017 is estimated at 8.5%, as agriculture rebounded from severe drought conditions, and industrial activity expanded on the back of continued investments in infrastructure and manufacturing.

The IMF forecasts growth to remain high in 2018, at 8.5%, supported by continued recovery from droughts and strong exports as new manufacturing facilities and infrastructure come online. The government is implementing the second phase of its Growth and Transformation Plan (GTP II), which will run to 2019/20. GTP II will continue to support the expansion of physical infrastructure through public investment projects, and the transformation of Ethiopia into a manufacturing hub. It is expected to underpin domestic private sector development and FDI, and support medium term growth, which is expected to remain around 8%.

Figure 1: GDP Growth and Inflation

Source: IMF World Economic Outlook (2017)

The key downside risks to the outlook are unfavourable weather conditions, as evidenced by the recent El Niño-induced drought, macroeconomic challenges associated with inflationary pressures and a widening current account deficit, and political uncertainty—although this is likely to be abated with the appointment of the new Prime Minister.

Inflation: Headline inflation has been trending higher in Ethiopia and reached 13.6% in December 2017 up from 6.7% in December 2016 partly on account of poor weather conditions as well as the devaluation of the Birr in October 2017. As a consequence, this has fanned inflationary pressures for food and non alcoholic beverages—especially bread and cereal prices—which have been rising steadily throughout 2017, peaking at 18.1% year-on-year in November 2017. Non-food inflation also ticked higher in December, to 9.4% year-on-year compared with 8.6% in the prior month reflecting creeping increases in the prices of clothing and footwear, construction materials, household goods and services. The weakening of the currency coupled with continued credit expansion is likely to sustain inflationary pressures in the short to medium term.

Exchange Rate: Ethiopia's currency is the "Birr" and the country's exchange rate operates under a managed floating regime – meaning that although the rate floats in forex markets, monetary authorities intervene when they deem necessary to limit undesirable fluctuations. In October 2017, the country started implementing a policy of gradual depreciation of the Birr. The Birr now stands at

Birr27.43:US\$1, compared to Birr23.40:US\$1, reflecting a 15% devaluation. This policy was adopted to attract FDI, enhance price competitiveness and boost exports which remain very low and ultimately narrow trade deficits. Despite this move, the IMF continues to exert pressure on Ethiopian monetary authorities for further devaluation arguing that the currency is still overvalued. In this regard, the ongoing policy of a gradual depreciation policy is likely to continue and could further weaken the Birr in the short to medium term.

Fiscal Balance: Official data shows an improvement in the government's fiscal balance in the 2016/17 fiscal year on account of a 9.6% increase in revenue juxtaposed with a 5.5% rise in government expenditure. The strong increase in government revenue during this period was on account of robust tax revenue, contributing 77.4% to government income.

The government is using these achievements as a blueprint for its fiscal policy in the short and medium term and expects to continue to boost tax revenue in 2017/18 fiscal year to support economic growth and modernization and expansion of infrastructure in priority areas such as health and education infrastructure. Nevertheless, revenue as a share of GDP remains low by regional standards and suggests upside potential in the government's attempt to broaden the tax base.

Overview of trade, reserves and financial sector

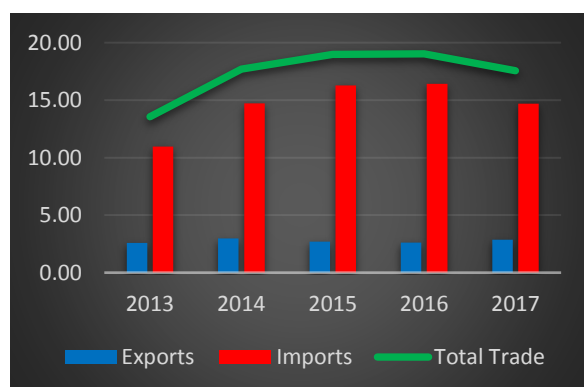
Total Trade: Ethiopia is the 91st largest export economy in the world and the 23rd largest export economy in Africa. In 2017, Ethiopia exported US\$2.86 billion and imported US\$14.7 billion, resulting in a trade deficit of US\$11.84 billion. This large trade deficit is on account of bulky infrastructure expansion projects, most notably the Ethiopia-Djibouti railway project that was launched in 2016, as part of the government's Growth and Transformation Plan.

Ethiopia's top imports include capital goods such as machinery, electrical goods and vehicles, but also refined petroleum, packaged medications, palm oil and fertilisers. Its top import origins are China, the US, India, Japan, and Italy which together accounted for more than 57% of total imports in 2017. Ethiopia mainly exports coffee, gold, leather goods and increasingly textiles and apparels and its top export destinations are the US, Saudi Arabia, Germany Switzerland and China.

Intra-African Trade: Ethiopia's total intra-African trade amounted to approximately US\$1.27 billion in 2017, accounting for around 7.2% of its total trade, significantly below the regional average of 15%. Although Ethiopia's share of intra-regional trade is relatively low, the country has a thriving trade relationship with its neighbours including Somalia, Djibouti, Sudan, and Kenya which account for the bulk of its destination markets in Africa. The main exports to Somalia are consumer perishable goods like fruits and vegetables, livestock, and chat. However, Ethiopia also exports electricity to Djibouti and Sudan; and pulses, cereal, leather, and tea to Kenya.

Ethiopia's largest African import trade partners are Morocco, South Africa, Egypt, Nigeria and Kenya which together accounts for over 95% of Ethiopia's total intra-African imports. It imports petroleum products, beverages, machinery, textile, soap and electrical products from Morocco, South Africa and Egypt and Nigeria and imports mainly fertiliser and textiles from Sudan. Meanwhile it imports textiles, food and live animals, machinery and fertiliser from Kenya.

Figure 2: Ethiopia's total trade, US\$ billion



Source: ITC Trademap, Afreximbank Research

Reserves: Ethiopia's reserve position has been trending up and reached US\$3.19 billion as of December 2017. However, given the country's ambitious infrastructure and development agenda, and particularly the size of its import bill in 2016, the current reserve position covers only about 2 months of imports. Further, as government projects enjoy priority in allocation of foreign currency, this is limiting the private sector's access to foreign exchange. The devaluation of the currency in October 2017 should help in easing pressure on demand for foreign reserves and incentivise FDI flows and tourism receipts which in recent

years have helped sustain the reserve position.

Current and Capital Account Balances:

Ethiopia has consistently run a current account deficit which widened considerably over the last five years, from -3.2% of GDP in 2012 to -11% of GDP in 2016, and is expected to remain virtually unchanged at -11.1% in 2017. The current account has been pressured by structural imbalances and deteriorating terms-of-trade as import growth continued to outpace export growth, along with widening deficit in services and primary income balances. Although the current account is expected to improve slightly during 2017-21 it will remain relatively high at 10% of GDP, on account of the large trade deficit driven by strong demand for capital goods.

The capital account has also been under pressure as foreign direct investment (FDI) continued to be adversely affected by restrictions on foreign participation in key economic sectors. Nonetheless, Ethiopia's business and economic potential, reflected by the size of the country's consumer market; the development of Special Economic Zones and Industrial Parks as well as infrastructure will continue to stimulate both private and public investments. These developments are expected to help improve the capital account and also positively impact the current account whose deficit is projected to trend down to below 10% of GDP by 2021 and financed by bilateral and multilateral loans and issuance of bonds.

Financial Sector: Despite the impressive growth performance in recent years Ethiopia's financial sector remains relatively small. Experts attribute this to protracted restrictions in the sector. Although the Government has allowed the establishment of private banks and insurance companies, it continues to prohibit foreign ownership in the sector. Foreign banks are not allowed to provide financial services in the country and the market is closed to foreign retail banks. These restrictions limit the lending capacity and development prospects of the sector, although recently, the country eased these restrictions by allowing foreign banks to establish "liaison offices" to facilitate credit to companies from their countries of origin.

Currently, the number of banks operating in Ethiopia is 18, of which 16 are private banks. The Commercial Bank of Ethiopia (CBE), a

state-owned bank, dominates the market in terms of assets, deposits and bank branches. Recently, CBE merged with the other state-owned bank – the Development Bank of Ethiopia (DBE) which provides loans to investors in priority sectors.

Total capital of the banking system is estimated at Birr78 billion (US\$2.8 billion). Of that total capital, private banks accounted for 35.6 percent while that of public banks (CBE and DBE) accounted for over 54% and 9.7% respectively or 64.4% together. Industry is the largest beneficiary of loans (25%), followed by agriculture (16%), and domestic trade (14%), and the remaining is shared among other economic sectors.

Over the last few years, the monetary authorities have undertaken a number of reforms to address liquidity constraints, including the reduction of reserve and liquidity requirements from 25% in 2012 to 5% currently and the use of mobile banking services. The growth of microfinance institutions (35 currently) which together mobilised about Birr26.3 billion in savings deposit with total assets estimated at over Birr50 billion at end of 2017, is expected to play an important role in supporting the reforms to address the liquidity and credit constraints in the sector.

Opportunities for Bank Support

Once seen as the byword for famine in Africa, strong economic growth in Ethiopia and development prospects are creating enormous opportunities across various sectors in the country and garnering attention from investors worldwide. Currently, there is an enormous funding gap for trade-supporting infrastructure in the country, particularly in the areas of transport and energy production. The Bank could aggressively enhance its presence, especially as the government increasingly relies on foreign banks and financial institutions to close the financing gap. In effect as government projects prioritise allocation of foreign currency, the private sector could fall back on the Bank to increase access to foreign currency.

As part of Ethiopia's strategy for growth and development, a key priority is industrialisation. This objective is in line with the Bank's key strategic objectives of transforming Africa through Industrialisation and Export

Development. In this regard, the Bank should aggressively pursue its support for the establishment of Industrial Parks and Special Economic Zones in the country. This will help increase value added products—especially in the agro-processing and light manufacturing industries like apparel, footwear and leather, diversify the sources of income and growth, and facilitate extra-and-intra African trade and in the process help the country narrow its widening trade deficit.

The tourism sector also presents opportunities for the Bank's CONTOUR Programme, given Ethiopia's rich cultural heritage and government's commitment to reposition the sector as a driver of growth. In effect the government plans for the sector to contribute 9% to GDP by 2024 against 2% currently.

Table 1. Ethiopia: Selected Macroeconomic and Financial Indicators

	2014/15	2015/16	2016/17	2017/18(f)	2018/19(f)	2019/20(f)	2020/21(f)
Real GDP, %	10.4	8	9	8.5	8.3	8.1	8.0
Inflation, %, Annual average	10.4	7.5	8.8	12.0	8.0	8.0	8.0
Exports of Goods and Services % y/y	-2.6	-3.5	2.9	12.9	13.4	13.9	14.2
Current Account (% of GDP)	-5.4	-8.1	-11	-11.1	-10.2	-10.2	-9.9
Gross Reserves (months of imports)	1.9	2.1	1.9	2.0	2.2	2.3	2.4
Total Government Debt, % GDP	54.0	55.4	56.9	59.0	58.1	55.5	53.1

Sources: World Bank, IMF