

Ethiopia
Macroeconomic Handbook 2019

CEPHEUS
RESEARCH & ANALYTICS

We put together ten questions often raised by investors during discussions of the Ethiopian macroeconomy, and venture to provide some answers that reflect our views and thinking on these issues. We also provide an Appendix with 10 years of macroeconomic data as well as our economic forecasts—covering the real, monetary, fiscal and external sectors—for 2019 and 2020.

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research@cepheuscapital.com

1. Is Ethiopia's development model about to change?
2. Can high growth rates continue?
3. What investments are driving growth?
4. When will single-digit inflation return?
5. Have debt levels become worrisome?
6. Can savings continue to rise?
7. Will banking keep booming?
8. Is the financial sector opening soon?
9. When could foreign exchange availability start improving?
10. Where is the Birr heading?

EXECUTIVE SUMMARY

- 1. Is Ethiopia's development model about to change?** Not in its fundamental goals or objectives, but surely in the tools and tactics employed. We see economic policy shifting its focus in three areas—from public to private activities, from capital to current spending, and from debt to equity.
- 2. Can high growth rates continue?** In short, yes, but as public-sector spending becomes more restrained, a strong private sector offset will be needed. The sub-sectors where expectations are highest (export-led manufacturing) may not be the best performing, but several domestic growth drivers will be strong substitutes.
- 3. What investments are driving growth?** The investments fuelling growth are becoming increasingly diversified—whether by asset type, by economic sub-sector, or by type of investor.
- 4. When will single-digit inflation return?** We expect a drop to 9 percent by end-March 2019, but inflation for most of 2019 will not fall much below the double-digit threshold.
- 5. Have debt levels become worrisome?** Debt servicing is really more of a challenge than debt levels, and even this only applies for public debt; private debt has plenty of room to grow.
- 6. Can savings continue to rise?** Further increasing savings rates will be tough among Ethiopia's domestic savers, but a big boost is possible and likely from foreign ones.
- 7. Will banking keep booming?** Yes, and for many more years in our view, given Ethiopia's still-low financial intermediation levels, untapped product offerings, and on-going investment activity. Shareholder returns will fall somewhat from recent highs, but not by much by our calculations.
- 8. Is the financial sector opening soon?** We don't see an opening to foreign investors till after 2020, but expect domestic players to soon start trading in marketable debt and equity instruments.
- 9. When could foreign exchange availability start improving?** In a matter of days, were the Birr allowed to float freely. But under the current foreign exchange regime (our base case scenario), we expect the improvement will take place gradually as multiple initiatives put in place to boost fx supplies—in exports, services, remittances, and FDI—begin to fully kick in.
- 10. Where is the Birr heading?** Absent a switch in the FX regime, we expect the central bank to adjust the Birr in line with inflation differentials vs trading partners and Ethiopia's balance of payments conditions; reflecting our forecasts for both, we see the rate at 30.1 ETB/USD by end-2019 and 31.7 ETB/USD by end-2020.

1. Is Ethiopia's Development Model About to Change?

Key points

- Ethiopia's economic policies have for a long time and for the most part followed the principles of a developmental state—involving a 'big push' by the state to jump-start priority activities, plus a heavy hand in charting the course of the agricultural, industrial, and financial sectors.
- Despite major economic reforms launched in 2018, there will not be—in our view—a fundamental departure from the developmental state approach, which we take as an economic policy framework that places *growth* as the overriding objective and where—in its pursuit—the state retains activist and interventionist policies with respect to *land, industry and finance*.
- Even so, the tools employed by policy-makers are clearly being modified, and we see economic policy shifting its attention in three areas—from public to private activities, from capital to current spending, and from debt to equity. Following recent reforms, we also expect policymakers to rely on a much more orthodox set of macroeconomic tools than was the case in the past.

Background

Ethiopia's approach to economic policy-making has long been described as being one of a developmental state—and for good reason. Since the start of the country's high-growth phase about 15 years ago, policy priorities have been heavily focused on boosting GDP growth, with massive efforts directed at boosting public investment and raising agricultural output. Budgetary spending, funded partly by enhanced revenue and substantially by new borrowing, was biased towards capital outlays and pro-poor spending in the form of infrastructure and social sector investments. Besides the 'growth-above-all-else' orientation that shaped a range of policy initiatives, the country's interventionist policies in the financial sector (ensuring low-cost funding sources as well as directed credit programs for priority projects) and in the industrial sector (active promotion of the emergence of certain sectors and industries) were all hallmarks of a developmental state. Other elements of the developmental state approach included 'getting prices wrong' in certain areas (via negative real interest rates for example), a closed capital account, government ownership of land (alongside user and leasing rights), and state engagement in certain productive activities—all of which, taken together, were dubbed as 'the Ethiopian Way' by the World Bank in one of the most extensive studies on Ethiopia's recent growth and development policies.¹

¹ See World Bank's "Ethiopia's Great Run" report, November 2015.

Not all of the government’s policies were those one would expect from a developmental state, however. For example, within agriculture—the economy’s largest employer and one of its largest sectors—laissez-faire policies were the norm: no subsidies were provided to farmers or minimum/maximum controls imposed their input or output prices. Trade policies were relatively liberal, with low average tariffs implying negligible efforts to provide infant industry protection for domestic industries. Perhaps most notable, exchange rate policies were not particularly geared towards boosting export growth as might have been expected—via highly competitive exchange rates—to be effected in a developmental state.

Still, despite the mixed record, the following four features taken together surely merit the designation of a developmental state: (1) GDP growth was taken as the over-riding policy priority above all else; (2) land ownership was retained in state hands allowing for discretionary allocations to address important policy priorities (e.g., public housing, urban expansion, industrial parks, commercial farm allocations, public roads/infrastructure, etc.); (3) the industrial sector was nurtured, shaped, and directed through a range of activist and interventionist tools steering economic activity towards certain priorities and not to others (tax exemptions, industrial parks, directed loans/foreign exchange from state banks); and (4) the financial sector was closely regulated to serve developmental policy priorities by mobilizing low-cost savings from large segments of society, raising ‘captive funds’ from the private sector (NBE Bills, private pension funds), and funnelling low-cost funds to government, state enterprises, and (partially via DBE) to the private sector.

Recent reforms and outlook

Looking ahead, a key question is whether economic policies under Ethiopia’s reformist new administration will remove or retain the developmental state approach of the past. We attempt to address this by reviewing the full scope of reforms put in place so far, by judging these changes against the core elements of a developmental state, and by asking whether it is the fundamental goals or only the tools, tactics, and timing that seem likely to change for the period ahead.

A set of sweeping economic policy changes have certainly been put in place in the ten months since the new administration of Prime Minister Dr. Abiy Ahmed took office in April 2018. The full scope of economic initiatives announced during the past year is presented below, based on a review of new policy announcements, the contents of the administration’s first new budget, the President’s (parliamentary opening) policy speech, the Prime Minister Office’s “New Horizon of Hope” one-pager strategy direction, and economic policy commitments under a newly agreed World Bank budget support loan.

Table 1.1: Ethiopia--Key Economic Reforms of 2018

Reform Area	Source/Note
1 Macroeconomic Policies	
Budget Deficit reduced to 3.4% of GDP for FY 2018-19, from 3.6% GDP last year	FY 2018-19 Budget--June 2018
No growth in government expenditure in real terms	FY 2018-19 Budget--June 2018
No public sector wage increase for the fiscal year	FY 2018-19 Budget--June 2018
Freezing of capital expenditure allocations for new public sector projects	FY 2018-19 Budget--June 2018
Reduced money supply growth (22% for broad money and 13% for reserve money)	IMF Article IV Report--Dec 2018
2 Private Sector Participation	
Part privatization of four big state enterprises (for airlines, telecom, power, logistics)	PM Office announcement
Full privatization of other state enterprises (sugar plants, railways, ind parks, others)	PM Office announcement
Continued smaller privatizations per regular norms	PM Office announcement
New Public-private partnerships for 17 infrastructure projects worth \$7bn	PM Office announcement
Planned opening of telecom sector to two additional licensees/operators	World Bank DPF Loan Document
Opening of logistics sector to (minority) foreign ownership	PM Office--"New Horizon of Hope"
Ensuring FDI into logistics sector of at least \$120mn	World Bank--DPF Loan Document
3 Boosting public sector resources and reducing public debt/liabilities	
Electricity price adjustments	World Bank--DPF Loan Document
Fuel price adjustments	Public announcements
Ethiopian Housing Corporation rental adjustments (in process)	Public announcements
Planned IFRS audit of 9 large SOEs to make their financial positions transparent	World Bank--DPF Loan Document
4 Reforms to Improve the Ease of Doing Business	
"Ethiopia's Action Plan for Jobs", covering 80 distinct actions across 10 Agencies	PM Office Announcement, Dec 2018
Cutting by 90% the share of new businesses requiring Certificate of Competency	World Bank--DPF Loan Document
Cutting by telecom (voice/data) prices by 50%	Ethio telecom
Plans to cut import and export transit times by half	PM Office--"New Horizon of Hope"
5 Banking reforms	
Removal of limits on diaspora (foreign exchange accounts)	National Bank of Ethiopia
Applying closer-to-market rate for NBE fx purchases from private banks	National Bank of Ethiopia
Easing of regulations on treatment of non-performing loans	National Bank of Ethiopia
6 Regional integration	
Normalization of relations with Eritrea, and start of transport/trade links	Public announcements
Planned re-starting use of Eritrean ports for shipping services (in process)	Public announcements

Source: As specified in table for each item.

Taken together, and as we see it, the reforms put in place this past year signal distinct changes in policy tools and in timing but not necessarily a shift in developmental approach. Privatization, for example, is not necessarily new (roughly 300 companies, collectively raising at least Birr 36 billion, have been privatized in the past two decades), but it is now being implemented with considerably greater breadth and depth. On the many set of issues related to the ease of doing business (procedures for company formation, registration, licensing, logistics), these have been addressed in piecemeal fashion in the past, but a much bolder, well-defined, and targeted effort seems to be now being put in place. With respect to macro policies, it is worth noting that a relatively 'conservative' and restrained stance has long been maintained for the *government budget* (with deficits limited to below 3 percent of GDP

and spending being cutback in line with revenue shortfalls), but what is different now is that *other parts of the public sector*—such as the state enterprises and public agencies—are also being subjected to greater fiscal discipline via a cutback in the scale of new borrowing, transparent audits, and privatization.²

More significantly, judging by the four developmental state ‘markers’ laid out earlier, a fundamental break from that approach to economic development seems unlikely. In particular, we see economic policy-making still guided by a vision that targets high GDP growth (critical to move towards middle-income status) and that continues to retain substantial scope—especially compared to the vast majority of African and developing countries—for activist state interventions in land, industrial, and financial policies. Looking at the four areas in more detail:

- **Growth:** Boosting growth, and the job-creation/income earning opportunities associated with it, remains the fundamental guide for economic policy per repeated policy statements given by the new Prime Minister and administration. However, it is clear that the *type* of growth will increasingly be given as much attention, with a greater likely focus on its qualitative dimensions (job/income creation and ultimate impacts on household consumption) as well as its underlying sources (more private-sector and consumption-driven and less debt-reliant, as elaborated below)
- **Land** will continue to remain in state hands for the foreseeable future, in our view, but be made available to the private sector via user rights (in agriculture) and long-term leases (in the urban/commercial sectors). The status quo provides policymakers extensive discretion in making priority allocations at the federal and regional level—be it for infrastructure, urban expansion, industrial parks, mining projects, commercial farming allocations, and other such projects deemed to be in the broader public interest. Such a heavy scope in the determination of land allocations is rare in developing countries—but also an undeniably powerful and potentially positive tool for a development-minded government working in the public interest.
- **Industry:** With respect to the industrial sector, a center-piece of policy initiatives in this area has been and remains the development of 20-plus industrial parks to establish an export-led manufacturing base in Ethiopia. As only about a quarter of industrial parks have been finalized so far (8 out of 22),³ and their performance is still in its early stages, we expect close and continued nurturing on the part of the government, including work to simplify the ease of doing

² Total public-sector financing averaged 9.5 percent of GDP on an annual basis in recent years (see IMF Article IV report of December 2018, Figure 3), but only 2.4 percent of GDP of this total was—on average—financing for government budget deficits while 7.1 percent of GDP was financing for state enterprise and other public sector entities.

³ Industrial parks that have started at least partial operations as of end-2018 include: (1) Eastern Industrial Park (private); (2) Bole Lemi; (3) Hawassa Industrial Park; (4) Mekelle Industrial Park; (5) Kombolcha Industrial Park; (6) Adama Industrial Park; (7) Dire Dawa Industrial Park; and (8) Jimma Industrial Park. Close to 150 firms are now active in these eight industrial parks.

business for Industrial-Park based companies (especially in overcoming logistics and labor challenges) and various other hand-holding support until key targets begin to be met.

- **Finance:** Unlike the openness to foreign capital planned in multiple areas (airlines, telecom, power, logistics), the dominant state bank was notably excluded from consideration for even a partial privatization and Ethiopia's financial sector remains one of the few worldwide that is closed to foreign investors. This signals that directed lending schemes, as is common for a developmental state, will remain an important element of the financial system, though it is important to recognize that various emerging financing sources will also be taking hold at the same time. Accordingly, we expect various important public-sector directed financing mechanisms—such as the allocation of public pension savings to government financing at low cost, the expansion of the DBE, and the NBE bills requirement on private banks—to remain in place as they facilitate the mobilization of low-cost funds to priority beneficiaries (including private beneficiaries, it must be noted, as in the case of DBE). With respect to the budget, its broad expenditure orientation and priorities—a significant share of pro-poor expenditure focused on delivering key public goods—is also not significantly altered as already seen in the June 2018 passage of the new administration's first budget. And finally, there are also no indications that the still-closed capital account would be up for opening as policymakers will aim (quite rightly at this stage) to restrict formal capital outflows so they may be channelled to domestic uses instead.

A different type of Developmental State?

While the approach taken towards economic development will thus retain the core elements of the past approach, we nonetheless see the emergence of a distinctly different type of developmental state. More specifically, we expect economic policy tools to shift their focus of attention from public to private activities, from capital to current spending (or investment to consumption), and from debt to equity. Also, we see policymakers working with a much more orthodox set of macroeconomic tools than was the case in the past. Some of these shifts were already beginning to emerge even before 2018, but it is clear that the recent reform drive will make the shifts broader, deeper, and faster than was the case before.

From public to private

The scale of public sector activities and initiatives in Ethiopia is on course to be substantially reduced in many areas, and a much more private-sector friendly developmental state is now clearly taking hold in our view. The clearest manifestation of this is seen from: (1) the large privatization program involving partial equity sales of the four largest state-owned firms; (2) plans to fully handover equity stakes in a range of other mid-sized state enterprises; (3) a policy commitment and institutional revamping to henceforth rely on public-private partnerships for large infrastructure projects, including through an already announced set of \$7 billion worth of infrastructure projects seeking private

partnerships; and (4) a very recent initiative announced in December 2018 to radically alter and improve the doing business environment for Ethiopia’s private sector.

Table 1.2: Planned Privatizations and Past Privatizations

1. Partial privatizations of four large state enterprises

- Ethiopian Airlines
Revenue of \$2.2bn and net profits of ~ \$230mn in FY 2017-18
- Ethio Telecom
Revenue of \$1.5bn and net profits of ~ \$700mn in FY 2017-18
- Ethiopian Shipping & Logistics Services Enterprise
Revenue of 0.68bn and net profits of ~ \$111mn in FY 2016-17
- Ethiopia Electric Power
Financial data not available

2. Full privatizations

- Ethiopian Railway Corporation
- Sugar Corporations
- Industrial Parks
- Other enterprises in agro-processing, mining, manufacturing, services

3. Largest Privatizations of the Past Two Decades- as of 2017

<u>Name of Enterprise</u>	<u>Birr mns</u>
1 National Tobacco	12,617
2 Meta Brewery S.C.	3,866
3 Bedele Brewery S.C.	1,445
4 Harer Brewery S.C.	1,323
5 Legedembi Gold Mine	1,290
6 Limu Coffee Agricultural Development	1,137
7 Upper Awasg Agro-Industry Enterprise(UAAIE)	860
8 Arsi Agri Dev't Enterprise	859
9 Bale Agri Dev't Enterprise	775
10 Tepi Green Coffe Estate s.c	733
TOTAL PRIVATIZATION TO DATE, in numbers:	291
TOTAL PRIVATIZATION TO DATE, in Birr mns:	36,067

Source: Company, press reports and official press release for company data; and Ministry of Public Enterprises Annual publication (Ametawi Metsehet No 1. Sene 2009) for past privatizations.

Table 1.3: Public-Private Partnerships: Announced deals as of Nov 2018

<u>Name</u>	<u>Capacity</u>	<u>USD mns</u>
Transport Projects		
1 Adama to Awash highway	125 kms	\$ 440
2 Awash to Meiso highway	72 kms	\$ 230
3 Meiso to Dire Dawa highway	160 kms	\$ 445
Power Projects		
4 Halele Warabesa hydro power project	424 MW	\$ 1,200
5 Dabus hydro power project	798 MW	\$ 984
6 Genale Dawa hydro power project 6	469 MW	\$ 793
7 Genale Dawa hydro power project 5	100 MW	\$ 387
8 Chemogada Yeda hydro power project	280 MW	\$ 729
9 Scaling Solar IPP Gad- Phase I	125 MW	\$ 150
10 Scaling Solar IPP Gad- Phase II	125 MW	\$ 150
11 Mekele Solar	100 MW	\$ 120
12 Humera Solar	100 MW	\$ 120
13 Welenchetti Solar PV project	150 MW	\$ 165
14 Weranso Solar PV project	150 MW	\$ 165
15 Metema Solar PV project	125 MW	\$ 150
16 Hurso Solar PV project	125 MW	\$ 150
17 Transmission and Substation project(18 projects)		\$ 1,100
TOTAL--Announced PPP projects		\$ 7,478

Source: Public press announcement and MOFEC

These four major shifts show a recognition of the public sector’s over-reach in recent years, and the likely end of large new state enterprise formations from here on. State involvement in the economy in recent years saw its entry into complex areas such as heavy metal industries, engineering works, sugar plants, and others. As has often been underlined by the new administration, the management expertise and project execution capabilities to run such complex entities has been in short supply in the public sector and, accordingly, policymakers have acknowledged a need to welcome private sector investment and management expertise in this areas.⁴ The explicit stance taken to either exit, sharply reduce, and/or re-assign to the private sector several major civil engineering works and industrial/manufacturing activities is also one of the clearest indications yet that policymakers will henceforth opt for a different set of tools (private investors rather state enterprises) than had been considered before. Indeed, it is reasonable to conclude that the establishment of large new state enterprises has come to an end, as has the reliance on dominant state enterprises for major productive activities within the economy.

⁴ In the case of Ethiopian Airlines, it is hard to argue that gaps in management expertise or skill sets were driving factors; instead, financial motivations seem much more important in that case—and not so much to fund the airline’s own future growth but rather to capitalize on and share its long-accumulated and built-up value for the broader public sector.

The financial magnitudes and implications of these announced public-to-private shifts is also worth recognizing. Privatization plans, as summarized in Table 1.2, could bring gains that are as high as a full year's worth of government tax revenues (i.e., as much as \$9 to \$13bn), judging from the recent profits of the companies involved and simple comparisons to market valuations of similar companies in other markets.⁵ On top of that, recently announced PPP projects of around \$7.5bn, though being implemented over many years, also amounts to almost another year's worth of government revenue; in many of these projects, it is expected that the private sector will raise the required funds and, in exchange, retain some ownership stake or share in some future stream of revenues. The FX infusion possible from both these sources (assuming mostly foreign equity involvement) is also significant in each case, amounting to several multiples of yearly goods exports and also several multiples of the current stock of foreign reserves. Thus, even when seen just in broad orders of magnitude, the mobilization of private funding from privatization and via PPP programs can potentially free up two-years worth of government revenue and three-years worth (in fx terms) of goods exports for re-deployment of funds in the many areas where spending by the state is needed to do its job well.

From capital to current spending (or investment to consumption)

In parallel with the growing space being created for the private sector, Ethiopia's growth model is in our view henceforth likely to follow a path that places a somewhat greater weight on consumption rather than investment—both due to the budgetary constraints of making new investments and given the need to rebalance the final use of resources after a decade of massive investment. Both investment and consumption can of course be expected to rise in nominal terms, but the *relative* size of the latter should begin to trend up in overall GDP. From a macroeconomic perspective, it is worth noting that Ethiopia has one of the world's highest investment-to-GDP ratios, which has helped build the physical hardware needed for a fast-modernizing economy. However, allocating close to 40 percent of a country's aggregate resources towards investment does—by accounting identity—imply a corresponding reduction in domestic consumption, unless foreign savings/resources can provide a partial offset. Such a squeeze in consumption relative-to-GDP has been evident from a national accounts perspective, which shows consumption down to 75 percent of GDP last year from a peak of 90 percent a decade ago. Expressed differently, as the focus of the past decade was (appropriately) on building up the country's hard assets and physical infrastructure (capital spending), much less has been

⁵ As summarized in Table 1.1, profits of the three large state enterprises for which data is available—Ethio Telecom, Ethiopian Airlines, and ELSE—were around \$0.7bn, \$0.2bn, and \$0.1bn respectively in recent years. A simple valuation exercise of using price-to-earnings ratios of 8x-12x (the common range observed for most of their peers in emerging markets) would suggest total valuations of \$9 to \$13 billion, and roughly equivalent equity injections were close to 50 percent of these firms open to equity investment. This of course ignores detailed information that would be needed on their (IFRS-based) financials, and also does not account for several potential adjustments related to their debt load (which would lower estimated valuations) or their likely stronger-than-comparables growth prospects (which would raise valuations). The regulatory/pricing/competitive environment in which the firms are allowed to operate would also be an important consideration. Still, these estimates are probably a reasonable balance of these offsetting factors, and—notably—do not account for equity inflows from the privatization of smaller state enterprises (beyond these largest ones) as well as large one-off inflows possible by sale of two new telecom licenses, as committed in recent policy documents (see Table 1.1).

spent *proportionately* on recurrent and consumption spending (including maintenance and wages for example); roads have been built but followed by limited allocations made for maintenance, universities have been constructed but less resources made available for recurring operational expenses, and similarly for the construction of public health and schooling facilities.

Some loosening of allocations for current and consumption spending is thus to be expected in the coming years—and early signs of this were actually beginning to appear since 2016.⁶ The most recent fiscal year, for example, has shown a fall in the budget’s share of capital expenditure, from 46 to 41 percent of total government spending, equivalent to a drop from 8.3 to 6.5 percent of GDP. At the same time, all new capital projects have been suspended, to allow existing ones to be fully funded and executed. More broadly, reflecting public sector restraint, the share of capital goods in total imports has fallen (from a peak of 41.8 percent four years ago to 34.5 percent of total imports in FY 2017-18), as has the overall investment-to-GDP ratio (from 39 to 34 percent of GDP over the same period). This rebalancing is likely to remain broadly in place in the coming years, in our view, as policymakers will likely find it important to ease years of sacrifice in domestic savings/investment by allowing somewhat more consumption (relative to income) in the years ahead.

Table 1.4: Trends in government capital and current spending, as well as capital goods imports

	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
Total Government Expenditure:	154	185	231	273	329	354
Govt capital spending, Birr bns	91	107	117	141	153	144
Govt capital spending, % total expenditure	59.2%	57.9%	50.8%	51.7%	46.4%	40.6%
Govt capital spending, % of GDP	10.5%	10.1%	9.0%	9.0%	8.3%	6.5%
Govt current spending, Birr bns	63	78	113	132	177	210
Govt current spending, % total	40.8%	42.1%	49.2%	48.3%	53.6%	59.4%
Govt current spending, % GDP	7.2%	7.4%	8.7%	8.4%	9.6%	9.6%
Total Capital Goods Imports:						
Capital goods imports (USD bns)	\$ 3.8	\$ 4.8	\$ 6.9	\$ 6.8	\$ 6.0	\$ 5.3
Capital goods imports (Birr bns)	69.7	92.6	138.5	144.5	135.5	138.2
Total Imports (USD bns)	\$ 11.5	\$ 13.7	\$ 16.5	\$ 16.7	\$ 15.8	\$ 15.3
Total Imports (Birr bns)	545	761	1,061	1,240	1,289	1,281
Capital goods imports to total imports	33.4%	35.3%	41.8%	40.8%	38.2%	34.5%
Capital goods imports to GDP	8.0%	8.7%	10.7%	9.2%	7.4%	6.3%
Capital goods imports to Govt capital spending	76.5%	86.2%	118.3%	102.4%	88.7%	96.1%
Memo items						
GDP (Birr bns)	867	1,061	1,298	1,568	1,833	2,202
GDP (USD bns)	\$ 47.6	\$ 55.5	\$ 64.5	\$ 74.1	\$ 81.6	\$ 84.0
Investment (Birr bns)	295.4	402.9	511.6	585.6	704.5	751.6
Investment-to-GDP ratio	34.1%	38.0%	39.4%	37.3%	38.4%	34.1%
Exchange rate (Birr/USD, year-average)	18.2	19.1	20.1	21.2	22.5	26.2

Source: MOFEC for Federal Budget and NBE for data on imports, GDP, investment, exchange rate

⁶ It is possible and indeed likely that some of this re-balancing was due to fiscal constraints and not necessarily reflective of deliberate policy choices; looking ahead, however, we would expect that a somewhat higher share of consumption spending (relative to GDP) will reflect more explicit policy preferences.

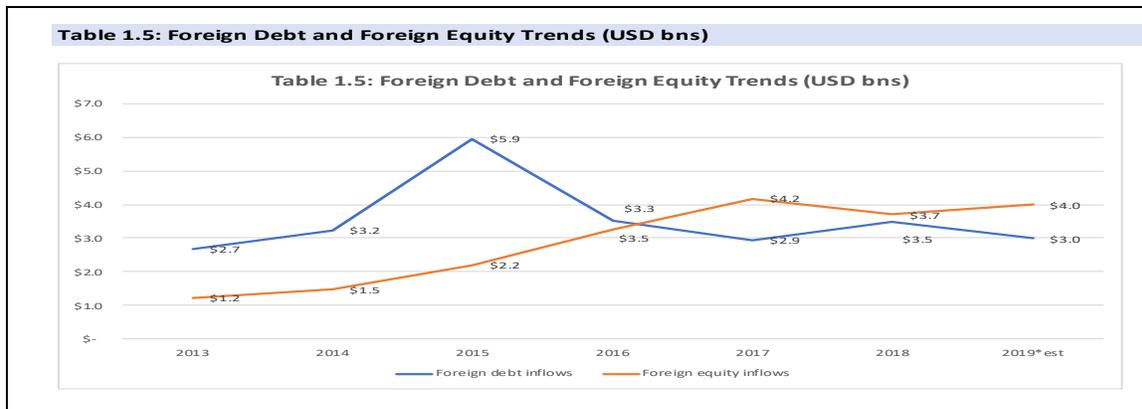
From debt to equity and use of own resources

Finally, after a decade of relying upon substantial amounts of domestic and external borrowing, the coming years are likely to show a moderation of debt accumulation by state enterprises as they make greater use of equity injections and their own (internally-generated) financial resources. Following substantial external debt reduction soon after the start of the new millennium, Ethiopia started its high-growth phase with a very low external debt base of just 11 percent of GDP in 2007/08 (external debt was 87 percent of GDP at its peak in 2002, prior to international debt relief granted by multilateral and bilateral lenders). Policymakers have—quite rightly—proceeded to use external savings/financing to deliver a range of public infrastructure investments in roads, power plants, health, education and related public goods. However, with public debt as of June 2018 at around 60 percent of GDP (with 30 percent of GDP in external debt), and given rising debt servicing costs, the scope for adding on more debt has diminished (see Chapter 5). The privatization program is thus a timely and appropriate means of substituting debt with equity, and of avoiding future debt liabilities by sacrificing some ownership stake in the accumulated value and net worth built-up in key public assets.

Beyond privatization, efforts to boost state enterprises' own resources are likely to be seen more widely as the public sector moves away from a heavy reliance on debt. This reform is essentially equivalent to enabling state enterprises to build-up their own equity or financing base, and is being observed with the electricity company (through gradual tariff adjustments, while shielding lowest-income consumers), the petroleum-importing enterprise (through recent adjustments in long-frozen fuel prices), the housing corporation (through its recent initiatives to revise long-frozen rental rates), and the public condominium housing projects (where price increases have been put in place to help cover one of the government's main urban initiatives whose costs—if fully implemented—will exceed that of the Grand Renaissance Dam project). Boosting the capacities of various public entities to cover their own costs may also be unavoidable in other areas—such as railways, water, etc.—thus ultimately reducing the public sector's reliance on large-scale debt accumulation.

Finally, for the specific cases of the largest state enterprises that are slated for partial privatization, the rebalancing in the use of debt vs equity financing sources is likely to be seen quite explicitly. Given their starting positions, the past approach of the state airlines, telecom, power, and logistics enterprises focused heavily on debt as a means of financing: Ethiopian Airlines, for example, raised its debt from Birr 3.6bn to Birr 62.6b (\$0.3bn to \$2.4bn) between 2010-11 and 2017-18 (per the past annual reports on its website and press release of 2017-18 results), while equity rose four-fold over the same period rose from Birr 8bn to near Birr \$32bn. For Ethio Telecom, we presume that their external debt now stands at \$1.2bn (taking the sum non-guaranteed state-enterprise debt in MOFEC debt data less EAL's debt). Based on NBE data on local bond issues, the electricity company's domestic debt has risen from Birr 65bn five years ago to Birr 216bn as of June 2018 (\$3.9 to \$7.9bn, or near 10 percent of GDP), again revealing a large reliance on debt financing, mainly from CBE. For all these cases, a presumed 49 percent part-privatization in the near future will significantly rebalance the composition of their financing sources, as the amounts raised in equity form could potentially be well in excess of

outstanding debt levels. Debt-to-equity ratios should thus improve sharply, possibly falling below 1x to the extent that the firms retain some part of the privatization-related equity injections (or any premium values) on their own balance sheets.



Conclusion

In sum, based on our judgement of recent reforms, the developmental state in Ethiopia is likely here to stay but in a form where the focus now is much more explicitly towards building the private rather than the parastatal sector. GDP growth will surely remain a top policy objective, as reaching middle-income status remains a national priority, but it is reasonable to expect more emphasis on aggregate consumption (to boost household incomes and living conditions) rather than primarily on investment, and a greater focus should also be expected on the qualitative rather than just quantitative aspects of growth. Similarly, while land policies are unlikely to change (remaining in state hands but with long-term leases available for the private sector), one can anticipate much greater sensitivity to displacements arising from development and investment initiatives, including improved approaches that better benefit both the affected communities and the private developers. In other areas, activist industrial policies are expected to stay in place (not least because of the state’s key role in building and managing over 20 industrial parks), but the actual work of manufacturing, exporting, agro-processing, and mining appears quite likely from here on to be entrusted predominantly to the private sector—including in those unconventional areas into which the state had ventured in recent years. And in finance, it is hard to see the dominant role of the large state bank being replaced any time soon, but it’s lending will increasingly support the private sector (as equity inflows and own resources cover a rising share of state enterprise needs), while the rapid growth of private banks and of other financing prospects (capital markets, foreign investment) will soon provide additional sources and instruments of private sector funding. Finally, the broad orientation of the government budget—a heavy focus on pro-poor expenditure—is also unlikely to be significantly altered. All of the trends anticipated above—the state’s continued focus on maintaining high GDP growth, its likely shift to doing a narrower set of functions that a state needs to do well, and its much more whole-hearted support of what is still in Ethiopia an emerging private sector—are in our view welcome, pragmatic, and promising directions that bode very well for the years ahead.

2. Can high growth rates continue?

Key Points

- Ethiopia’s high rates of growth can continue for many more years, in our view, but as public-sector spending becomes more restrained, a strong private sector offset will be needed.
- Looking at specific economic sub-sectors, medium-term growth prospects are encouraging in agriculture (large scope for yield improvements from still-low levels), manufacturing (with the launch of 20-plus industrial parks), mining (as multiple new projects begin to come on line), construction (still-large backlog of unmet residential and industrial needs), and services (ongoing expansion in airlines, tourism, and logistics).
- For the immediate period ahead, 2019 and 2020, growth will probably fall short of expectations in some areas where there are high hopes (export-led manufacturing), but large expansions should be forthcoming in domestic-focused sub-sectors such as services, construction, and agriculture. We think there are strong reasons to expect growth of at least 9 percent for the current fiscal year.

In 2018, Ethiopia experienced its 15th year of strong growth and at the same time the slowest growth in 15 years. In this context, we ask three questions about the growth outlook. *First*, if one of the main drivers of past growth (large-scale public-sector investment) is being scaled back, what might serve as a substitute in the coming years? *Second*, can Ethiopia still rely on the financing sources—particularly the sharp rise in both domestic savings and in external borrowing—that were critical in fuelling past growth? *Third*, considering a range of growth determinants, what kind of growth rates should reasonably be expected for the near-term?

Table 2.1: Growth Over the Past Five Years—Main Economic Sectors and Sub-sectors

	2013-14	2014-15	2015-16	2016-17	2017-18	5-Yr Avg
GDP growth:	10.3%	10.4%	8.0%	10.1%	7.7%	9.3%
Agriculture	5.4%	6.3%	2.3%	6.7%	3.5%	4.8%
Crop sector	6.6%	7.2%	3.4%	8.2%	4.7%	6.0%
Industry	17.0%	19.8%	20.6%	20.3%	12.2%	18.0%
Manufacturing	16.6%	18.2%	18.4%	24.7%	5.5%	16.7%
Mining	-3.2%	-25.6%	-3.3%	-29.8%	-20.8%	-16.5%
Construction	6.8%	4.5%	25.0%	20.7%	15.7%	14.5%
Services	13.0%	11.2%	8.7%	7.5%	8.8%	9.8%
Hotels and Restaurants	26.6%	29.6%	15.6%	0.1%	6.5%	15.7%
Transport and Communication	12.7%	13.3%	13.7%	15.1%	6.4%	12.2%
Banking Sector	-12.2%	14.3%	9.6%	18.3%	10.7%	8.1%
Public Admin and Defense	11.0%	6.0%	7.4%	13.2%	8.9%	9.3%
Health and Social Work	12.3%	19.3%	10.8%	7.0%	8.3%	11.5%

Source: NBE

Table 2.2: Ranking of Sectors by Growth Rate: 5-year average and most recent year

Ranking--FY 2017-18 Growth by Sub-Sector			Ranking--Past Five Years, Annual Average Growth		
1	Construction	15.7%	1	Construction	23.4%
2	Wholesale and Retail Trade	12.3%	2	Large and Medium Scale Manufacturing	18.6%
3	Fishing	11.3%	3	Hotels and Restaurants	17.9%
4	Banking Sector	10.7%	4	Fishing	15.0%
5	Public Admin and Defense	8.9%	5	Transport and Communication	12.2%
6	Health and Socail work	8.3%	6	Banking Sector	12.1%
7	Hotels and Restaurants	6.5%	7	Health and Socail work	11.7%
8	Transport and Communication	6.4%	8	Wholesale and Retail Trade	11.4%
9	Real Estate, Renting and Other	6.2%	9	Small Scale and Cottage Industries	10.4%
10	Large and Medium Scale Manufacturing	6.0%	10	Public Admin and Defense	9.3%

Source: NBE

Understanding past growth

Ethiopia’s past growth has certainly been driven in strong part by public sector investment. As widely recognized, the build-up of extensive public infrastructure (roads, rail, power, telecom, water systems) has contributed a significant share of recent growth, as have massive public-sector investments in health and education. Further public-sector investments in the agriculture—equivalent to 10 percent of the budget—also worked to improve the ‘super-structure’ of markets and institutions in that sector, most notably by improving input availability (seeds, fertilizers) and encouraging better farming practices (via a large ‘army’ of extension workers, model farmer programs, and the like).⁷ Reflecting the aggregate significance of such public-sector interventions, the World Bank’s decomposition of growth (between factor inputs and productivity) finds a strong role of for both higher productivity as well as increased factor inputs such as labor, capital, and land. For agriculture, in particular, World Bank analysis has found that about 45% of the increased crop output reflected an increase in three primary inputs (land, labor, capital), 22% was due to higher productivity, 12% reflected better seeds, and 8% was due to more fertilizer use.

At the same time, the growth story has not simply been one of expanding state activity. There has been a widening of the overall economic base towards newer areas in which the private sector has been active, particularly services and construction. Even in agriculture, for example, the ten-year increase in production (from 16.1mn to 30.6mn tons), in acreage (from 10.9mn hectares to 12.7mn hectares), and in yields (from 1.47 tons/hectare to 2.41 tons/hectare) reflects not just the impact of

⁷ As highlighted by World Bank analysis (see “Ethiopia’s Great Run report”), only 4 African countries devoted 10 percent of their budget to agriculture, and the country’s farmer extension program was noted for having the highest ratio of extension workers-to-farmer in the world. References to growth decomposition are also derived from this World Bank report.

multiple public-sector interventions but also private sector initiatives and responsiveness (i.e., the results of 15 million farm households throughout Ethiopia adopting more and/or better seeds, fertilizers, tools, and farming practices). As in agriculture, construction expansion appears to reflect the joint impact of both public sector and private sector initiatives, the former for driving public infrastructure and the latter in executing projects (as contractors) for both public projects as well as for private developments such as the vastly increased numbers of commercial and residential buildings seen throughout major cities. Finally, on services, we see again the strong role of public sector expansion (public employee numbers are up from 0.6 million ten years ago to near 1.5 million as of 2018) and of private sector in the form of rapid expansion in retail trade, hotels, banking, and private health and education services. In each of the above areas, the role of private sector growth and expansion has been critical to supplement public sector interventions—whether that refers to the millions of small holder farmers that capitalized on a more favourable set of opportunities, construction sector operators implementing a range of public/private projects, or service sector enterprises in trading, hotels, banking, and other areas responding to rising demand in their respective domains.

Table 2.3a: Contributions to GDP Growth, by main economic sectors

	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
GDP growth	10.0%	10.3%	10.4%	8.0%	10.1%	7.7%
<i>Of which, contribution from...</i>						
Agriculture	3.1%	2.3%	2.5%	0.9%	2.5%	1.3%
Industry	2.8%	2.2%	2.7%	3.1%	4.7%	3.1%
Services	4.1%	5.8%	5.2%	4.0%	2.9%	3.3%

Source: NBE

Table 2.3b: Contributions to GDP growth by top ten detailed sub-sectors

	2015-16	2016-17	2017-18
GDP growth	8.0%	10.1%	7.7%
<i>Of which, contribution from...</i>			
1 Construction	2.0%	3.4%	2.8%
2 Wholesale and retail trade	1.4%	0.9%	1.7%
3 Crop sector	0.9%	2.0%	1.1%
4 Public Admin and Defense	0.4%	0.6%	0.4%
5 Large and Medium Manufacturing	0.9%	0.8%	0.3%
6 Transport and Communication	0.7%	0.7%	0.3%
7 Financial Intermediation	0.2%	0.5%	0.3%
8 Real Estate, Renting and Other	0.3%	0.2%	0.3%
9 Hotels and restaurants	0.8%	0.0%	0.2%
10 Animal farming and hunting	-0.1%	0.4%	0.1%

Source: NBE

Table 2.4a: Composition of GDP by 3 main economic sectors, 10-year Trend

	2007-08	2013-14	2014-15	2015-16	2016-17	2017-18
Agriculture	45.9%	40.2%	38.7%	36.7%	36.3%	34.9%
Industry	12.1%	13.8%	15.0%	16.7%	25.6%	27.0%
Services	40.6%	46.6%	47.0%	47.3%	39.3%	39.2%

Source: NBE

Table 2.4b: Composition of GDP--Ranked by GDP sub-sectors showing the largest change in the past decade

	2007-08	2013-14	2014-15	2015-16	2016-17	2017-18	2018 vs 2008
Construction	4.0%	6.9%	8.2%	16.4%	18.0%	19.3%	15.3%
Large and Medium Scale Manufacturing	2.5%	3.4%	3.8%	4.3%	4.6%	4.5%	2.0%
Small Scale and Cottage Industries	1.4%	1.2%	1.1%	1.9%	2.4%	2.3%	0.9%
Public Administration and Defense	3.6%	5.1%	4.9%	4.3%	4.4%	4.5%	0.9%
Transport and Communications	4.2%	4.7%	4.8%	4.9%	5.1%	5.0%	0.8%
Private Households with Employed	0.3%	0.2%	0.2%	1.1%	1.0%	1.0%	0.7%
Financial Intermediation	2.4%	2.4%	2.3%	2.7%	2.9%	3.0%	0.6%
Education	2.1%	2.0%	2.0%	2.9%	2.6%	2.5%	0.4%
Health and Social Work	0.7%	1.0%	1.0%	1.1%	1.1%	1.1%	0.4%
Fishing	0.0%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%
Hotels and Restaurants	2.6%	4.5%	5.3%	2.9%	2.6%	2.6%	0.0%
Electricity and Water	1.2%	1.0%	1.0%	0.8%	0.7%	0.7%	-0.5%
Mining and Quarrying	0.8%	1.3%	0.8%	0.4%	0.3%	0.2%	-0.6%
Whole Sale and Retail Trade	15.9%	16.5%	16.8%	14.0%	13.5%	14.1%	-1.8%
Animal Farming and Hunting	10.9%	8.3%	7.8%	10.1%	9.6%	9.0%	-1.9%
Forestry	5.2%	3.5%	3.3%	3.4%	3.2%	3.1%	-2.1%
Crop sector	33.4%	28.3%	27.5%	23.9%	23.5%	22.8%	-10.6%
Real Estate, Renting and Business	7.5%	7.9%	7.4%	4.6%	4.4%	4.3%	-3.24%
Other Community , Social & Personal	2.8%	2.4%	2.3%	1.3%	1.2%	1.2%	-1.62%

Source: NBE

Table 2.5: GDP Composition--The Largest GDP sub-sectors as of June 2018, and their ten-year trends

	2007-08	2013-14	2014-15	2015-16	2016-17	2017-18
Crop sector	33.4%	28.3%	27.5%	23.9%	23.5%	22.8%
Construction	4.0%	6.9%	8.2%	16.4%	18.0%	19.3%
Whole Sale and Retail Trade	15.9%	16.5%	16.8%	14.0%	13.5%	14.1%
Animal Farming and Hunting	10.9%	8.3%	7.8%	10.1%	9.6%	9.0%
Transport and Communications	4.2%	4.7%	4.8%	4.9%	5.1%	5.0%
Large and Medium Scale	2.5%	3.4%	3.8%	4.3%	4.6%	4.5%
Public Administration and Defense	3.6%	5.1%	4.9%	4.3%	4.4%	4.5%
Real Estate, Renting and Business	7.5%	7.9%	7.4%	4.6%	4.4%	4.3%
Forestry	5.2%	3.5%	3.3%	3.4%	3.2%	3.1%
Financial Intermediation	2.4%	2.4%	2.3%	2.7%	2.9%	3.0%
Hotels and Restaurants	2.6%	4.5%	5.3%	2.9%	2.6%	2.6%
Education	2.1%	2.0%	2.0%	2.9%	2.6%	2.5%
Small Scale and Cottage Industries	1.4%	1.2%	1.1%	1.9%	2.4%	2.3%
Other Community , Social &	2.8%	2.4%	2.3%	1.3%	1.2%	1.2%
Health and Social Work	0.7%	1.0%	1.0%	1.1%	1.1%	1.1%
Private Households with Employed	0.3%	0.2%	0.2%	1.1%	1.0%	1.0%
Electricity and Water	1.2%	1.0%	1.0%	0.8%	0.7%	0.7%
Mining and Quarrying	0.8%	1.3%	0.8%	0.4%	0.3%	0.2%
Fishing	0.0%	0.1%	0.1%	0.1%	0.1%	0.1%

Source: NBE

The broad-based nature of growth sources is captured by alternative indicators of economic activity that need not rely solely on GDP statistics. Such non-GDP indicators serve as an alternative to national accounts statistics, whose reliability may be questioned because of weaknesses in coverage, compilation, or methodology. These indicators broadly support the existence of strong growth, even if one may question the precise figure reported for growth. In particular, double-digit growth rates are seen in much more readily quantifiable areas such electricity demand (11%), air cargo volume (18%), shipping cargo volume (25%), vehicle registrations (13%) and real deposit levels (13%). In addition, one observes high single-digit growth in fuel consumption (9%), real loan levels (8%), and tourist arrivals (6%).

Table 2.6: Alternative Indicators of Growth

Non-GDP Growth Indicator:	2014-15	2015-16	2016-17	2017-18
Fuel consumption volumes	7.6%	7.8%	13.0%	9.6%
Electricity demand	9.4%	9.9%	19.8%	11.0%
EAL cargo volume	27.1%	12.4%	27.2%	18.2%
EAL passenger numbers	7.3%	19.5%	15.4%	21.0%
Tourist arrivals	18.8%	19.0%	4.0%	6.0%
Vehicle registrations	13.0%	20.6%	17.3%	12.6%
Djibouti port traffic	6.3%	8.5%	25.0%	25.0%
Export volume growth	-6.9%	8.8%	5.3%	-1.6%
Import volume growth	0.0%	27.7%	-6.8%	6.8%
Real tax collections	13.8%	7.3%	1.9%	-2.7%
Real deposit levels	15.0%	11.8%	21.0%	13.7%
Real loan levels	23.1%	13.2%	20.6%	8.2%
Real money supply	14.3%	12.4%	20.0%	14.5%
Average of above indicators	11.4%	13.8%	14.1%	10.9%
Median of above indicators	13.0%	12.4%	17.3%	11.0%

Source: NBE, EAL, EPE, Federal Transport Authority

In short, while past growth can be said to have been dominated by public sector drivers, it has also been supported by an expanding private sector; looking ahead, however, with greater restraint in public sector activity (per Chapter 1), the burden of maintaining growth will lie much more heavily on boosting supply within the private sector. And for the private sector to take on this burden, it will be more critical than ever that: (1) the state do well those functions that only it can do well (security, public goods, basic health and education); (2) the ease of doing business improves substantially to allow simplified company formation and growth; and (3) financing becomes more readily available to help finance private sector expansion. In all three areas, the orientation of recent reforms is precisely towards these directions, boding well for medium-term growth.

Financing Future Growth

A review of the *financing* of past growth reveals that high growth was fuelled by high investment rates, which in turn was made possible by a jump in both domestic savings and external debt accumulation. Looking at the past five years, average investment to GDP ratios of near 37 percent have led to average growth rates of near 9 percent over the same period, indicating that roughly 4 percent of GDP in new investment is driving approximately 1 percentage point of GDP in growth. Moreover, of the 37 percent average investment to GDP ratio seen in the last five years, the equivalent of 22 percent of GDP was funded from domestic savings, while the remaining 15 percent of GDP was covered via externally-generated resources in the form of remittances, grants, loans and FDI. In essence, the momentum of Ethiopia's growth has been driven by keeping high investment rates at 34-39 percent of GDP (which translated to growth rates of 8-10 percent) and by financing that high investment with *both* an expanded pool of domestic savings (24 percent of GDP in FY 2017-18 from below 10 percent of GDP a decade ago) and through much increased financing resources (particularly debt) from the rest of the world.

Looking ahead, while the dominant financing sources of the past are moderating or plateauing, there are emerging substitutes that can prevent a drop in GDP growth. Even if investment rates are scaled back somewhat from recent highs (as argued in Chapter 1), they will very likely remain in the neighbourhood of 34-36 percent of GDP, and the needed savings/financing sources to sustain growth will thus remain correspondingly high. And with public sector borrowing becoming more restrained, resources available to maintain growth would appear likely to fall significantly, thus cutting growth. However, as highlighted earlier, while foreign debt may not rise as fast as in the past, it is being substituted by foreign equity, and while the public sector's foreign borrowing is becoming more restrained, the private sector's foreign borrowing is beginning to rise (see Chapter 5). Moreover, while investment may moderate somewhat (no longer reaching almost 40% of GDP), we are likely to see an offset from an improved efficiency of—increasingly private sector—investment, such that 4 percent of GDP in investment is no longer required to yield 1 percentage point of GDP in growth. Thus, in principle at least, growth can continue at or close to recent rates as long as there is a sufficient offset in the nature of the investment flows (more private-sector driven) and in their composition (more equity to compensate for moderating debt).

Considerations for Future Growth

At a very high level and seen in broadly qualitative terms, the influences on Ethiopia’s growth involve a number of macroeconomic, sector-specific, policy, political economy, investment climate, and external considerations. We present some of these influences, both on past growth and on the medium-term outlook, and qualitatively summarize our observations and the implications for near-term growth in Table 2.7. In broad terms, we find that the economy’s supply side and demand side growth drivers should remain in place, though perhaps with compositional shifts whereby manufacturing and agriculture become more important than services, and where consumption may deliver a stronger growth impulse than investment. Seen from the perspective of the economic actors driving growth, while the public sector is likely to be showing more restraint in the coming years (reflecting debt considerations), this can—and likely will—be substituted by the private sector, thus limiting possible growth slowdowns. Macro policies, reflecting a more orthodox fiscal and monetary stance, will probably be less conducive to growth in the short-term, but should not necessarily be so in the longer term and can, in any case, provide even a shorter-term boost if more is done to boost external competitiveness. In most other areas, the prospects for growth are either much improved or no worse than recent years: whether looking at investment climate considerations (ease of doing business reforms are now singled out as a policy priority and are being aided by World Bank support); the impact of public confidence and sentiment (which has been quite positive considering diaspora/remittance flows); or from a political economy perspective (where greater political openness may contribute to a more complicated policy process in the near-term, but could at same time deliver more durable pro-growth policies and outcomes over the longer term). Finally, while the external environment facing Ethiopia is clouded by potential drags on growth from low commodity prices and a possible slowdown in global trade, this would be offset in some areas (lower oil prices imply a lower fuel bill) and there is also on the horizon a potentially important growth boost from a much improved regional geopolitical and economic environment, especially prospects for deeper trade/investment relationships with Eritrea, Sudan, Somalia, Djibouti and Kenya.

Table 2.7: A Qualitative Review of Growth Influences: Ethiopia's Past Record and Future Outlook

Growth Determinants across different dimensions:	Past Growth	Growth Outlook
1 Role of GDP supply side growth determinants (agriculture, manufacturing, services)	Expansion across all three boosted growth, though most heavily from agriculture & services in earlier years, and construction in most recent years	Growth still likely to be broad-based, but more dominant role seen from industry and agriculture, less from services (See Table 2.10)
2 Role of GDP demand side growth determinants (consumption, investment, government, net exports)	Consumption was as high as 90% of demand five years ago, but is now 75%; investment 34% GDP in 2017-18, but near 38% in prior four years	Somewhat more consumption and less investment likely to follow after a decade of high savings and investment
3 Role of economic actors: public sector, private sector, corporate sector, household sector, financial sector,	Public sector expansion key, as was financial sector in boosting savings/intermediation	With public sector restraint expected, more growth contributions expected from private sector, particularly corporate and financial sector within it
4 Role of macroeconomic sectors: Real, Fiscal, Monetary, and External sectors	Activist fiscal and monetary policies important, less growth boost from external sector	Less role likely for unorthodox fiscal, monetary policies, but possibly more focus on external sector competitiveness
5 Role of factors of production: Capital, Labor, Land and of Productivity (TFP)	Large expansions in capital, labor, land were key, while productivity (TFP) was also a high share of growth, per WB analysis	Continued focus on boosting capital, labor, and land use, but shift to industries with higher output-per-worker (e.g. manufacturing) may boost contribution from productivity
6 Role of labor force participation: Per Capita GDP = [Labor Force/Population] x [Output/Labor Force]	Large expansion in employment was important as was Total Factor Productivity (TFP)	Continued expansion in employment should propel per capitaGDP growth
7 Confidence and sentiment indicators and expectations across key sectors (domestic private sector, portfolio investors, ratings agencies, etc)	Not very meaningful given lack of private capital markets and no external portfolio flows	Economic sentiment/expectations to become more important as capital markets/FDI become more important. Positive sentiment contributing to higher remittance inflows
8 Policy commitment , primacy given to growth, and internal organization for growth	Strong "everything-for-growth" policy drive and orientation	Strong "everything-for-growth" policy drive and orientation likely to remain in place, but more focus also likely on type and quality of growth
9 Policy execution capacity for growth	High execution capacity given strong federal government and centralized decision-making	Strong execution capacity likely to remain in place, but regional competition and policy differences may also bring differences in regional growth
10 Political Economy factors/explanations:	Political unrest and instability in 2016 and 2017 dampened growth in those years, but more stable conditions in earlier years had facilitated investment and growth	Period of political reform may bring tensions/uncertainties, including in run up to 2020 elections, but also offers positive prospects for a more durable and consensus-based political economy in the longer-term
11 External influences on domestic growth [global commodity prices, export/import prices, global interest rates, risk to emerging markets]	Mostly favorable external environment for growth during 2008-14, but turned adverse in 2014-18. Risk appetite towards emerging markets not of much significance for Ethiopia.	External influences positive on falling oil prices, but still adverse for low commodity prices (coffee, sesame). Risk appetite towards EM/FM may matter more given start of capital markets

Source: Cepheus Research

Table 2.8: Ethiopia's Medium-Term Growth Considerations by Specific Sub-Sectors

AGRICULTURE

Crops	Arable land: Only 15% percent of arable land cultivated; large scope for new cultivations Commercial farming sector largely unexploited (except horticulture) but huge potential Irrigation: Boosting currently low (10%) irrigation coverage would boost yields Yields can be raised sharply with widening of model farmer practices and pilot programs Initiatives in contract farming, waste reduction, & in other areas
Fruits & Veggies	Horticulture: Exports of \$230mn at present, but land allocation to sector being doubled High value crops such as herbs, spices still relatively untapped but with large prospects Cargo/cold-storage infrastructure now in place at AA airport to handle large export volumes
Livestock	Large scope to better develop Africa's largest and world's 6th largest livestock population

INDUSTRY

Mining	Explorations underway for gold, potash, iron ore, copper, silica, and others Oil explorations on-going, with encouraging finds in 2018 and more likely in 2019-20 Natural gas production expected from recent explorations over coming years
Manufacturing	22 industrial parks under development, 150 firms so far in 8 operational industrial parks Large local market offers huge scope for FMCGs: foodstuffs, homecare, personal care, Rising SME numbers with boost this sub-sector
Construction	Still-substantial govt allocations for road, public works, infrastructure will propel growth Govt housing development plans likely to be re-started, including with foreign participation Several dozen high-rises under construction in AA's business and banking districts Private real estate projects (including foreign ones) likely to increase given relaxed rules
Power	On-going dam projects include GERD, and close to half-dozen other smaller dams Two large geo-thermal projects under process, each of \$4bn value if fully executed

SERVICES

Hotels and Restaurants	Dozens of star-rated hotels in pipeline, with 5,000-plus room expansion likely in few years Several initiatives (on entry visas, conference promotion, tour packages) will boost inflows
Trading	Wholesale and retail trade will rise with overall economic activity and population growth
Transport & Comm	Rising urbanization, pop growth, airline/rail expansion will drive continued expansion
Financial Sector	Still-strong momentum in bank deposit/lending growth given unmet/pent-up demand
Real Estate	Loosening of rules for foreign entry likely to boost real estate services Sector's large pent-up demand could multiply with greater financing options for buyers
Public Admin	Large population expansion (~2mn per year) will imply rising public admin services
Education	Large population expansion (~2mn per year) will boost (public/private) education offerings
Health	Large population expansion (~2mn per year) will boost (public/private) health offerings

Source: Cepheus Research

Outlook for 2019 and 2020

With respect to specific forecasts for FY 2018-19, we see the record crop harvest expected for late 2018, improved private external inflows, and continued expansion in domestic services as the basis for projecting higher growth this year compared to last year's 7.7 percent. In particular, we see the following outlook across the main economic sub-sectors:

- Agriculture:** Given favourable rains across most regions throughout the main rainy season (July-September 2018), expectations are for a record crop harvest at end 2018. More specifically, we anticipate total acreage farmed will have reached 10.4mn hectares this year (up from 10.2mn last year), and assuming slightly better yields than last year, major crop production should grow by 6-7 percent and exceed 32 million tons (up from 30.6mn tons last year). This strong growth in the core economic sector will feed through to other closely allied sectors including transport, services, and agro-processing based manufacturing.

TABLE 2.9: Agricultural Production and Growth

	Agriculture Produce (Mns of tons)				Cultivated Area (Mns of hectares)				Yield (tons per hectare)			
	2015-16	2016-17	2017-18	2018-19	2015-16	2016-17	2017-18	2018-19	2015-16	2016-17	2017-18	2018-19
Major Crops	26.7	29.0	30.6	32.6	12.5	12.6	12.7	12.9	2.14	2.31	2.41	2.53
Cereals	23.1	25.4	26.8	28.6	10.0	10.2	10.2	10.4	2.32	2.48	2.62	2.75
<i>of which:</i>												
Maize	7.2	7.9	8.4	...	2.1	2.1	2.1	...	3.39	3.68	3.94	...
Teff	4.5	5.0	5.3	...	2.9	3.0	3.0	...	1.56	1.66	1.75	...
Sorghum	4.3	4.8	5.2	...	1.9	1.9	1.9	...	2.33	2.52	2.73	...
Wheat	4.2	4.5	4.6	...	1.7	1.7	1.7	...	2.54	2.68	2.73	...
Pulses	2.8	2.8	3.0	3.2	1.7	1.6	1.6	1.6	1.68	1.82	1.86	1.95
Oilseeds	0.8	0.8	0.9	0.9	0.9	0.8	0.8	0.8	0.91	1.04	1.01	1.01
	Growth Rates--PRODUCTION				Growth Rates--AREA				Growth Rates--YIELDS			
	2015-16	2016-17	2017-18	2018-19	2015-16	2016-17	2017-18	2018-19	2015-16	2016-17	2017-18	2018-19
Major Crops	-1.3%	8.8%	5.4%	6.5%	-0.6%	0.7%	0.8%	1.5%	-0.8%	8.1%	4.6%	4.9%
Cereals	-2.0%	9.8%	5.5%	6.7%	-1.7%	2.5%	0.1%	1.5%	-0.4%	7.1%	5.4%	5.1%
Pulses	3.6%	1.6%	5.8%	7.0%	6.1%	-6.2%	3.1%	2.5%	-2.3%	8.4%	2.6%	4.4%
Oilseeds	3.2%	6.9%	1.9%	0.0%	0.4%	-6.3%	5.1%	0.0%	2.9%	14.1%	-3.1%	0.0%

Source: CSA's Agricultural Sample Survey Reports, Figure for 2018-19* are Cepheus research projections

- Industry:** Industry as a whole should continue to show strong growth on the back of construction and power expansion, as has been the case in recent years. The growth contribution of industrial parks is not yet likely to be as high as construction, given that most are in their early stages. Also, given the still-high reliance on imports for firms in industrial parks their output will—at least in the near term—be more important for boosting gross exports and job-creation rather than for increasing value-addition, i.e. GDP.

- **Services:** On the services side, banking trends in the first quarter of the year suggest a slowdown in activity (growth was only 5 percent for deposits and 4 percent for loans in the period between end-June and end-September 2018), but some pick-up is likely in the coming months and annualized growth rates suggest deposit growth can reach 22 percent and loan growth 20 percent for this fiscal year. Other areas such as airlines and tourism show strong momentum for the year based on Q1 data, with airline passenger numbers likely to go up from 10.6 to 12mn this year and tourism inflows from 1.11 million to 1.24 million; the latter two areas should be boosted by recent reforms on visitor visa requirements and other sector-specific initiatives. Service sectors such as local usage of hotels, rentals, entertainment are also likely to show strong growth given much strong remittance flows so far for this year; CBE alone reported \$1bn in remittance flows for just the July-September quarter, suggesting close to \$6 billion in total remittance flows is possible for this year—a record 6.3 percent of GDP—after also accounting for private bank inflows.
- **Taxes and Trade:** Beyond sector-specific trends, other macro data suggest somewhat weak trends so far in the fiscal year. The performance of tax collections, for example, is up only 8 percent (in nominal terms) for the first five months of the fiscal year compared to the same period last year (Birr 82bn vs Birr 77bn), but it is not yet clear if this is mainly due to weak tax collection or a broader slowdown in growth as well. Also suggesting weak economic activity are recent import data, which were down 9 percent in the first quarter of the fiscal year (\$3,682mn in July-September 2018 vs \$4,034mn during the same period last year); the import slowdown likely reflects fx constraints and implicit quantitative rationing, however, and may thus not tell us much about broader growth developments. Exports, which are only around 3 percent of GDP and have had a loose relationship with GDP for many years, were also weak so far in the year (down 7 percent in the first quarter of the fiscal year, or just \$628mn vs \$678mn in the same period last year). In all three cases, as the data only represent a few months outturns, we do not read too much into these early signals, though a continuation of such trends for the next two quarters would warrant a reconsideration of this year’s growth outlook.
- **Overall GDP growth:** All things considered, we project growth of 9.0 percent for 2018-19, given our sub-sector projects of 6.5 growth in agriculture, 12 percent in industry, and 8.8 percent in services. For FY 2019-20, based mainly on agriculture returning to a more trend growth rate, we forecast GDP growth of around 8.5 percent.

TABLE 2.10: Growth Projection by Sector: FY 2018-19

	2016-17	2017-18	2018-19
Overall GDP	10.1	7.7	9.0
Agriculture	6.7	3.5	6.5
<i>Of which: Major crops</i>	<i>8.2</i>	<i>4.7</i>	<i>6.5</i>
Industry	20.3	12.2	12.0
<i>Of which: Construction</i>	<i>20.7</i>	<i>15.7</i>	<i>14.0</i>
<i>Of which: Large Manufacturing</i>	<i>19.2</i>	<i>6.0</i>	<i>8.0</i>
Services	7.2	8.8	8.8

Source: MOFEC-NBE for historical data, Cepheus projection for FY2018-19

Compared to other forecasts for the Ethiopian economy, our growth projections are somewhat above the median. Our compilation of more than a dozen projections of FY 2018-19 growth show forecasts are as high as 11 percent (Ministry of Finance and Economic Cooperation) and as low as 7.2 percent (Economist Intelligence Unit). The median across all growth projections is 8.3 percent. We believe we are somewhat more optimistic than the median due to our expectations for growth rates in agriculture (reflecting our more positive judgement on this year’s crop harvest) and in services (we see a stronger impact from private remittance and capital inflows than is perhaps assumed by others).

Table 2.11: Growth Projections for Ethiopia, FY 2018-19

Institution	Growth proj.
1 Ethiopia's Ministry of Finance	11.0%
2 International Monetary Fund	8.5%
3 World Bank	9.1%
4 African Development Bank	7.8%
5 Economic Commission for Africa	7.5%
6 Economist Intelligence Unit	7.2%
7 Renaissance Capital	8.5%
8 NKC-Oxford Economics	7.6%
9 Focus Economics	7.8%
10 Standard & Poor's	8.0%
11 Fitch	9.5%
12 Moody's	8.0%
13 Rand Merchant Bank	8.2%
14 Standard Bank	8.0%
15 Ecobank	8.5%
16 Cepheus Capital	9.0%
<i>Consensus Average</i>	8.3%
<i>Consensus Median</i>	8.0%

Source: MOFEC and websites/reports of the respective institutions

As with any economic projections, the anticipated growth rates are of course not without risks and implicitly assume certain baseline assumptions regarding the domestic political economy and policy environment. In our projections, we assume stable political conditions, particularly in the run up to the 2020 elections, and a continuity in the recently launched policies of the new administration. We also expect that the execution of macroeconomic and sector-specific policies will be broadly in line with announced plans, per the Government’s 2018-19 budget, the Prime Minister’s ‘New Horizon of Hope’ one-pager strategy document, and the Government’s own reform commitments (especially to ease the doing business environment) as set out in the recent World Bank lending package. Should these baseline assumptions not hold, investment activity by the local private sector could be held back and foreign investment inflows also reduced, implying that the recent restraint in public sector spending is not sufficiently offset by private sector expansion.

Could growth turn out even higher? Yes, some targeted policy reforms could potentially return growth back to double-digit levels for a sustained period. In our view, such growth accelerators could involve: (1) an active promotion and establishment of large commercial farms (targeting several dozen private commercial farms for key crops/fruits/vegetables may merit as much policy attention and priority as the establishment of several dozen large industrial parks); (2) a rapid implementation of—and securing quick wins in—the recently launched campaign to improve Ethiopia’s Doing Business rankings; (3) promoting the emergence of large ‘domestic champions’ and ‘super-star’ companies (particularly exporters) in line with much recent literature that emphasizes the unique role of a few dozen such large firms in driving export and manufacturing growth;⁸ (4) a possible immediate move to a market-clearing rate exchange rate to remove serious distortions and bottlenecks in this area (see Chapter 9); and (5) a push to put in place a national digital payment system (with state direction if need be, per the Indian model) that facilitates a range of payment types (P2P/P2B/P2G), enables e-commerce activities, and boosts small entrepreneurship and access to credit. Needless to say, each one of these areas would call for certain enabling conditions in the policy and regulatory environment as well as possible targeted and temporary state support, while the feasibility of each in the Ethiopian context would also warrant close review. Even so, the examples of Rwanda (in improving its Doing Business rankings), of South East Asia (in promoting large exporters), and of Kenya and India (with contrasting models for transformative innovations in the digital and payments space) are inspiring and worth emulating as both growth accelerators and job creators in the Ethiopian context.

⁸ See, for example, World Bank Policy Research Working Paper 6222 on ‘Export Superstars’ based on data from a sample of 32 developing countries, and recent McKinsey analysis (“Outperformers: High Growth Emerging Economies and the Companies that Propel them” of September 2018) on the outsized impact of large firms in recent ‘outperformer’ economies.

3. What investments are driving growth?

Key points

- **As high investment has been the fuel propelling Ethiopia's strong growth, we look closely into what exactly comprises investment—by type of asset, by economic sub-sector, and by type of investor.**
- **Though not widely recognized, private investment has overtaken public investments in recent years and now makes up more than half of total investment in the economy. Most of this private investment has—so far—been driven by domestic rather than foreign sources. By asset type, investment is concentrated on infrastructure/civil works and capital equipment outlays, while by economic sub-sector, it is dominated by flows into industry (which includes construction) as opposed to agriculture or services.**
- **Looking ahead, we forecast that private investment will soon make up close to two-thirds of total investment (thus 2x public investment) and will increasingly come from foreign sources.**

Ethiopia stands out among most African and developing countries for its consistently high investment rates in recent years. Total investment to GDP averaged 39 percent of GDP for the four years between FY 2013/14 and FY 2016/17, compared to a Sub-Saharan African average of 20 percent of GDP, Middle East average of 29 percent of GDP and an Asian average of 30 percent of GDP. Among African countries, Ethiopia has the one of the highest rate of investment even after a drop to 34 percent of GDP registered in the most recent fiscal year ending in June 2018.

Expressed in monetary terms, investment has risen to Birr 750 billion in FY 2017-18, up from Birr 403bn five years ago, and Birr 83bn a decade ago. In USD terms, investment is now around USD 29bn per year, up from just USD7.6bn decade ago. Put in a cross-country context, the USD 29bn of investment in Ethiopia is not far from the absolute levels seen in much bigger economies (investment stood at USD 38bn in Egypt and USD 52bn in Nigeria) and also double the investment levels of economies closer to Ethiopia's size (\$15bn in Kenya and \$14bn in Tanzania).

Looking beyond the high investment levels, we attempt to decompose its underlying components by type of asset, by economic sector, and by type of owner. From a national accounts perspective, the total of Birr 752 bn (USD 29bn) in aggregate investment can be broken down along the following three dimensions:

- **Investment by asset type:** By definition, investments are comprised of five main asset types, namely: (1) infrastructure outlays (such as for roads, rail, power, water systems, etc); (2) machinery and plant equipment; (3) building-related civil works (for public sector, commercial, and residential uses); (4) transport vehicles including trucks and vehicles; and (5) land improvements, including irrigation and similar projects. While such a breakdown of investment

components is not publicly available for Ethiopia, we would highlight the following figures to approximate the magnitudes involved—and their estimated rankings— across the various asset types:

- **Infrastructure projects** (road, rail, power, and related projects): Annual spending in this area would be as high as Birr 300bn in FY 2017-18, if the full government capital budget (Birr 144 bn) and state enterprise use of financing (Birr 129 bn) were assumed to be devoted to infrastructure/civil works outlays. A more realistic range is that about two-thirds to three-fourths of these totals represent infrastructure projects, implying an estimated range of Birr 280bn to Birr 293bn (the remainder would be comprised of machinery/equipment plus buildings-related civil works; see below).
- **Machinery and plant equipment:** Capital goods imports provide a good approximation in this area, given the very limited local production of such hardware, and would suggest amounts of as much as Birr 105bn (taking Birr 145 bn in total capital goods imports last year less vehicle and trucks imports).
- **Building-related civil works:** The scope of investment in this area would include the full range of government-led civil works projects (universities, schools, health centers), large state-enterprise led building projects (public housing, industrial parks) plus private residential and commercial building developments. Calculated as a residual (given figures for the four other investments by asset type), the total amount of investment in this area is estimated to be in the range of Birr 250bn to Birr 300bn.
- **Vehicle and truck imports:** Vehicle and trucks imports were near Birr 30bn in FY 2017-18, as these items are recorded explicitly in import statistics.
- **Land improvement:** This might be approximated by federal government agriculture spending, which has in recent years amounted to around 10 percent of government expenditure. Assuming most federal government agriculture spending is devoted to investment, this comes to an estimated Birr 35bn in annual land-related investments for FY 2017-18.
- **Investment by economic sector:** As the national accounts classification of “industry” covers manufacturing, construction, and mining, we would expect most investment lies within this economic sub-sector. This assumption is supported by figures for the composition of capital goods imports, which show that about 75 percent of capital imports are in the form of *industrial* capital goods. Extrapolating a similar share for broader economic-wide investment would imply industrial-related investment of near Birr 564bn. With agriculture-related investments outlays likely to be in the range of Birr 35bn (as derived above), this implies the residual category of service sector investments amounts to Birr 153bn.

- **Investment by asset owner:** Detailed investment data by asset owner would offer breakdowns by public vs private investors, residential vs non-residential investments, and foreign vs domestic. Again, for broad orders of magnitudes involved, available data suggest the following:
 - **Government:** The FY 2017-18 budget showed that out Birr 340bn in total government expenditure, Birr 144 bn was allocated for capital expenditure. By asset type, government’s capital spending would include infrastructure outlays, equipment purchases, civil works, and land improvements.
 - **State Enterprises:** Data on state enterprise capital expenditure can be inferred from their total use of financing from the domestic banking system and from external borrowing. Per NBE data, SOE use of financing (both domestic and external) was Birr 130bn in FY 2017-18. Assuming virtually all financing is used for capital expenditure (a reasonable assumption) and that at least 30 percent is raised from state enterprises’ own resources, the total financing secured of Birr 130bn translates into total estimated SOE capital expenditure of around Birr 184bn.
 - **Private Sector:** Given total FY 2017-18 investment of Birr 751bn in the national accounts, and subtracting out the above figures for government and state enterprise capital spending, the estimate for private sector investment is—as a residual—around Birr 478bn. Foreign investment of \$3.7bn or Birr 100bn would be included in this sum and taking that out would suggest around Birr 378bn in *domestic* private sector investment.

Table 3.1: Investment Components, approximate distribution

	2015-16	2016-17	2017-18	2017-18
Total Investment-Birr bns	586	705	752	100%
By Type of Asset	586	705	752	100%
Infrastructure (75% of public capex)	220	222	293	39%
Plant, Machinery, and Equipment	112	103	109	14%
Buildings & civil works (residual)	194	314	286	38%
Transport vehicles	32	32	30	4%
Land improvements	27	33	35	5%
By Economic Sub-sector	586	705	752	100%
Agriculture	27	33	35	5%
Industry	439	528	564	75%
Services	119	143	153	20%
By Economic Actor	586	705	752	100%
Public Sector	256	260	328	44%
Federal Government	141	153	144	19%
State Enterprises	115	107	185	25%
Private Investments	330	444	424	56%
Domestic investors	261	351	326	43%
Foreign investors	69	94	98	13%

Source: NBE, IMF, Cepheus Research for estimates of investment composition

Despite the patchy data, and admittedly rough nature of estimates involved, the above review reveals some notable observations. First, capital goods imports are actually a small share of total investment (Birr 144bn out of Birr 752bn, or roughly one-fifth), revealing that most infrastructure and civil works investments are comprised of inputs and materials sourced from domestic producers (such as local producers of cement and construction materials), and that a significant part of the economy's investment can thus continue even if there are constraints on imported resources. Second, even after accounting for large state enterprise investments, the private sector is undertaking more than half of total investment in the economy (Birr 478bn out of Birr 751bn), despite the common impression that capital spending is dominated by the public sector. Third, while foreign investment is up sharply in recent years, it has so far been only a small part of the overall investment activity in Ethiopia, as it represents 13 percent of total investment (Birr 100bn out of Birr 751bn). It has, however, grown over the years to make up an increasingly higher share of private investment and in FY 2017-18 reached one-fifth of total estimated private investment (Birr 100bn out of Birr 479bn).

Looking ahead, what do recent trends suggest about the investment outlook? We would highlight the following likely trends:

- **Overall investment to GDP:** Per national accounts statistics, the investment-to-GDP ratio has fallen to 34 percent of GDP in 2017-18, from an average of 38 percent of GDP in the prior four years. While this may reflect data problems (including a revision in the base year used for GDP statistics), it is consistent with the lower growth recorded (just 7.7 percent last year vs 10 percent in the prior four years) and could also reflect the political unrest in several regions of the country that held back public, domestic, and foreign investment activity. With conditions normalizing this year as well as next (a baseline assumption), the investment rate should pick up somewhat, though it will probably not revert back to the near-40% rate seen in 2014/15 since we think (as elaborated in Chapter 1) there may be less resources and motivation to use resources for investment as opposed to consumption. We think that an investment rate in the mid-30s range (34-37 percent of GDP) will likely also reflect policy preferences, and this should be supported by large privatization proceeds (of potentially as much as 2-3 percentage points of GDP) as those funds are expected to be realized 2019-20 and 2020-21 and largely assumed to be directed for investment purposes. But beyond the impact of the privatization proceeds, which would take investment ratios to the upper end of the 34-37 percent range, we do not anticipate a big jump in the investment to GDP ratio from last year's levels of 34 percent of GDP.
- **Investment composition and drivers:** The composition of investment will clearly shift to private sector investors, and we forecast that private investment will reach close to two-thirds of total investment in the economy and thus stand at two-times the level of public investment. In other words, of the total 37 percent of GDP investment, private investment should comprise 24 percent of GDP while public sector investment (government and state enterprises) will make up only around 12 percent of GDP in new investments. Foreign investment on its own should reach close to a fourth of total private investment, or near 6.3 percent of GDP. Beyond the sizeable impact of privatization and on-going reforms, the projections for FDI will be supported by a

range of private sector equity inflows, including infrastructure-related public-private partnerships, industrial park inflows, mining sector ventures, power generation projects (including two large geo-thermal plants), oil and gas explorations, and new real estate projects involving solely private and joint public-private ventures.

Table 3.2: Investment Outlook for FY 2018-19 and 2019-20

	2017-18	Projections	
		2018-19	2019-20
Total Investment--Birr bns	751	904	1,116
Public Sector	328	354	397
Government Investments	144	157	183
State Enterprise Investments	185	197	214
Private Investments	424	550	718
Domestic private investors	326	424	525
Foreign direct investment	98	126	194
Total Investment--% of GDP	34.1%	34.5%	36.5%
Public Sector	14.9%	13.5%	13.0%
Government Investments	6.5%	6.0%	6.0%
State Enterprise Investments	8.4%	7.5%	7.0%
Private Investments	19.2%	21.0%	23.5%
Domestic private investors	14.8%	16.2%	17.2%
Foreign direct investment	4.4%	4.8%	6.3%
Total Investment--% of Total	100%	100%	100%
Public Sector	44%	39%	36%
Government Investments	19%	17%	16%
State Enterprise Investments	25%	22%	19%
Private Investments	56%	61%	64%
Domestic private investors	43%	47%	47%
Foreign direct investment	13%	14%	17%
Total Investment--USD bns	\$ 28.6	\$ 32.2	\$ 37.4
Public Sector	\$ 12.5	\$ 12.6	\$ 13.3
Government Investments	\$ 5.5	\$ 5.6	\$ 6.2
State Enterprise Investments	\$ 7.0	\$ 7.0	\$ 7.2
Private Investments	\$ 16.1	\$ 19.6	\$ 24.1
Domestic private investors	\$ 12.4	\$ 4.5	\$ 6.5
Foreign direct investment	\$ 3.7	\$ 15.1	\$ 17.6
Memo items:			
GDP--Birr bns	2,202	2,621	3,056
Exch rate	26.23	28.11	29.80
GDP--USD bns	\$ 84.0	\$ 93.2	\$ 102.6

Source: NBE, IMF and Cepheus Research for composition estimates/projections

4. When will single-digit inflation return?

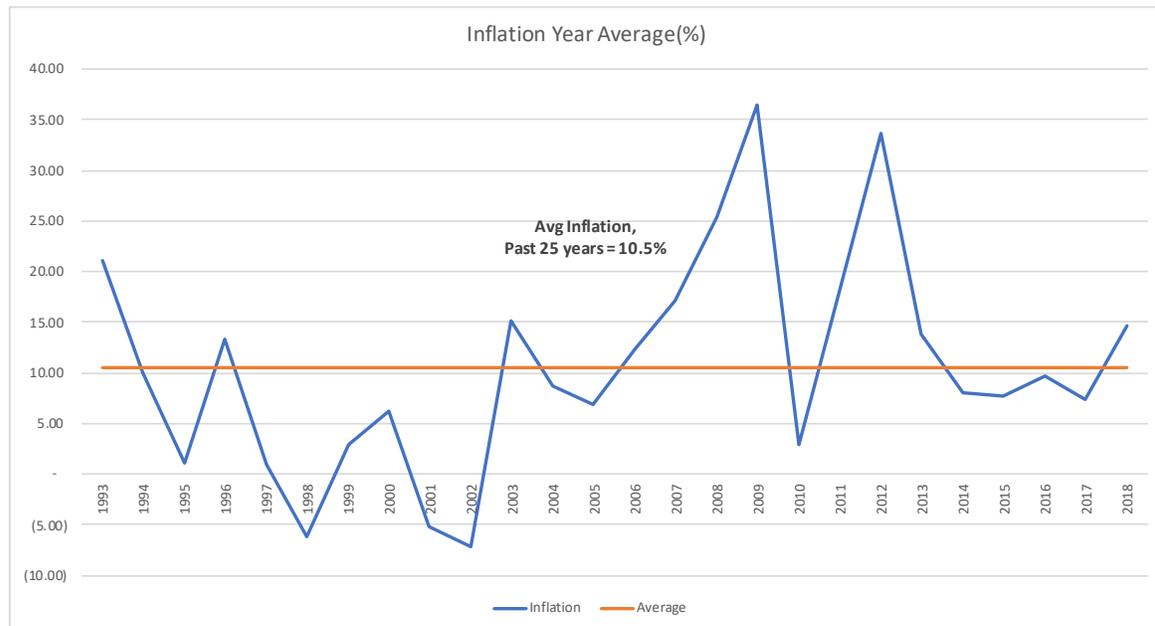
Key points

- **We review inflation data over the past quarter century and find that single-digit inflation has been in place more often than not, or for 15 out of the 25 past years. We also find that average inflation rate over the past 25 years has been around 10.5 percent, almost identical to current levels.**
- **We expect (year-on-year) inflation to hit single-digits at end-March 2019, as month-on-month inflation rates have turned negative in recent months, and since price pressures should remain subdued for a few more months per the usual (post-harvest) seasonal norms.**
- **However, inflation will not fall much below the double-digit threshold for most of 2019. A rapid freeing of some administratively set prices, excessive monetary growth, and rising global oil prices could push inflation back to the mid-teens—though all three seem unlikely at the moment.**

Looking back at a quarter century of Ethiopian inflation data shows single-digit inflation has been more common during this time (15 out of 25 years) than double-digit inflation. Focusing on the last 15 years, corresponding to the period of high growth, one finds that single-digit inflation has been in place roughly half the time, with 7 out of 15 years registering single digit inflation. And for the most recent period, one finds that four out of last five years registered single-digit inflation. The past 18 months of double-digit inflation thus represents an exception rather than the norm, and indeed median inflation over the past 25 years as a whole has been around 9 percent. The latest available inflation reading shows inflation of 10.4 percent at end-December 2018, down from a 2018 peak of near 16 percent in February 2018.⁹

⁹ The CPI index was rebased (using Dec 2016=100) on January 8, 2019 with the release of end-December 2018 inflation data. The new data series shows double-digit inflation for all of 2018, except for a drop to 9.3 percent in November 2018 followed by a return to double-digit inflation in December 2018. The latter likely reflects a mid-November adjustment in fuel prices, which would appear in transport and related prices during December 2018.

TABLE 4.1: Inflation over a 25-Year Perspective



Source:CSA

Seen from this context, the following features of Ethiopia’s recent inflation are noteworthy:

- Food rather than non-food prices:** A decomposition of inflation by type of commodity reveals that increases in food prices (up 11.3 percent vs year ago for December 2018) contributed more to inflation than non-food prices (up 9.2 percent). This is particularly important as food prices make up 54 percent of the price index (among the highest such ratios globally), and within this sub-component, cereal crops, meat, and milk/eggs explain the vast majority of food price movements. As those three items were precisely those registering high price increments (16.2 percent for cereals, 17.7 percent for meat, and 14.2 percent for milk/eggs), inflation in food items has stayed stubbornly high. As these products are not heavily imported and also generally not exported in large quantities, high domestic demand and the possible impact of domestic unrest has likely helped push up these price levels after five years of relatively modest annual increases.
- Goods more than services:** A split of the consumer price index along these lines indicates goods inflation has been higher at 11 percent (weighted average for goods) than seen for services (9.5 percent), suggesting perhaps the effect of more competitive conditions and supply responses in the latter rather than the former. Services items such as health, utilities, and communications were notable for showing single-digit or even negative inflation.

- **Imports versus domestic products:** Goods with heavy import content showed inflation of 12.4 percent, somewhat than average higher inflation rates for mainly domestically produced goods and services (10.2 percent). As the devaluation was 15 percent, an almost full price through to import prices appears to have been effected for imported goods.
- **Addis Ababa versus regional capitals:** Inflation is somewhat lower in the capital city (10.4 percent) than it is in regional capitals (the top 3 regions with the highest inflation showed rates of 14 to 21 percent), reflecting the larger weight of food within regional inflation indices. Transport interruptions encountered for food and other commodities, and the localized nature of markets in certain areas, may also explain higher inflation in the regions than in the capital.
- **Monetary influences:** With respect to monetary policies, there is a slight indication that higher money supply growth may have contributed to higher inflation in FY 2017-18. Average inflation in the five years prior to FY 2017-18 was just 8.5 percent and money supply growth over the same period was lower than it has been last year—overall banking system credit (broad money) grew on average by 24.9 percent per year and central bank funds (reserve money) grew by 17 percent per year. By contrast, growth in both broad money and reserve money was higher at 29.2 percent and 19.1 percent respectively in 2017-18 when inflation rose to 14.7 percent for the year to June 2018. However, this simple inference is not definitive on its own as it does not account for other influences on inflation (including product markets and external factors). Also, looking more narrowly at just government borrowing from the central bank (the most inflationary form of financing), growth in this line item was 18 percent in 2017-18 and not that different from average annual growth during the prior five years (19 percent per year on average), suggesting that extra inflationary pressures did not arise—within the last year—from this particular source. Still, some level of influence has likely been exerted from slightly higher money supply growth last fiscal year compared to the prior five years, and indeed inflation might have been somewhat lower had credit growth last year been less than actually registered.

Table 4.2: Recent Inflation Trends: Year-on-Year Change in Consumer Prices

	<u>OVERALL PRICE INDEX</u>	<u>OVERALL INFLATION</u>	<u>FOOD INFLATION</u>	<u>NON-FOOD INFLATION</u>
	<i>Weights:</i>	<i>100%</i>	<i>54.0%</i>	<i>46.0%</i>
Oct-17	114.2	12.6	14.0	12.2
Nov-17	116.1	15.7	16.0	15.9
Dec-17	116.5	16.6	15.5	17.7
Jan-18	117.7	16.7	15.7	17.9
Feb-18	118.2	16.1	16.4	15.5
Mar-18	120.6	15.5	13.7	17.6
Apr-18	120.8	14.0	11.4	17.3
May-18	122.4	15.3	11.9	19.4
Jun-18	125.2	16.8	14.2	20.1
Jul-18	126.7	15.3	13.5	17.5
Aug-18	127.1	14.2	13.8	14.8
Sep-18	128.5	11.9	10.7	13.2
Oct-18	128.1	12.1	9.5	15.4
Nov-18	126.7	9.3	9.3	8.8
Dec-18	128.6	10.4	11.3	9.2

Source: CSA, shaded boxes mark peak-month of inflation since the Oct 2017 devaluation

Table 4.3: Inflation Outturns by key analytical categories -- DECEMBER 2018

	CPI Weights	Weights within Category	Inflation
A. Domestically Produced and Domestically Consumed			13.0%
1 Bread and Cereals	18.8%	52%	16.2
2 Alcoholic beverages and tobacco	4.9%	14%	0.3
3 Other food products	4.8%	13%	9.0
4 Meat	4.4%	12%	17.7
5 Milk, Cheese, Eggs	2.2%	6%	14.2
6 Sugar, jam, honey and others	1.0%	3%	10.8
<i>Sub-Total</i>	36.1%	100%	
B. Domestically produced but also heavily exported			8.0%
1 Vegetables	13.6%	73%	10.2
2 Non- alcoholic beverage and coffee	4.7%	25%	1.4
3 Fruits	0.3%	2%	8.6
<i>Sub-Total</i>	18.6%	100.0%	
C. Import-Heavy Commodities			12.4%
1 Clothing and footwear	5.7%	34%	14.6
2 Furnishings, Household Equipment, and others	4.7%	28%	18.1
3 Oils and Fats	3.8%	23%	-0.1
4 Miscellaneous goods	2.5%	15%	15.2
<i>Sub-Total</i>	16.7%	100.0%	
D. Services			9.5%
1 Housing, water, electricity, gas, other fuels	16.8%	59%	6.1
2 Restaurants and Hotels	5.3%	18%	13.2
3 Transport	2.5%	9%	12.2
4 Health	1.5%	5%	7.7
5 Communication	2.0%	7%	-3.0
6 Recreation and culture	0.4%	1%	9.5
7 Education	0.2%	1%	15.7
<i>Sub-Total</i>	28.7%	100.0%	
Overall inflation	100.0%		10.4

Source: CSA and Cepheus Research for categorizations

To make a final observation on recent inflation drivers, we provide a snapshot of *price level* data for over a dozen of items with some of the highest weights in the (Addis Ababa) consumer price index. Data for September 2018 are used as these price level data are made available by the Central Statistical Agency with a few months lag. The price level data for Addis Ababa show food prices being driven by high increases in several widely-consumed staples such as cooking oil (61 percent), wheat barley (31 percent), and teff (25 percent). Prices from sources other than the Central Statistical Agency (CSA) for a few readily available price indicators broadly align with the CSA data, showing significant increases for wheat (36 percent), teff (27 percent), and maize (15 percent), which are broadly similar to the percent increases found in the CSA data.

Table 4.4: Snapshot of price level changes driving recent inflation

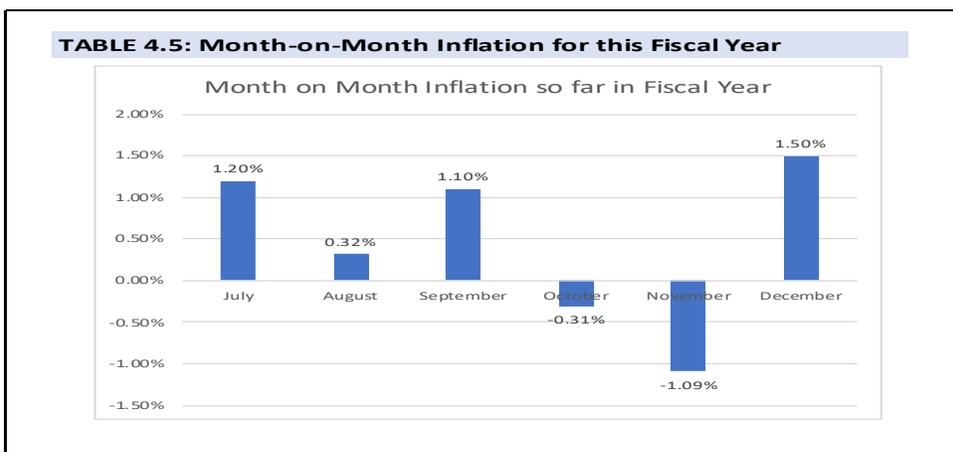
	<u>Weights</u> <u>in CPI</u>	<u>Sep-17</u>	<u>Sep-18</u>	<u>% change</u>
Food Items				
Meat per kg	3.47	172.3	185.3	8%
Sugar per kg	2.02	24.7	19.6	-21%
Wheat per kg	1.45	13.0	16.9	31%
Cooking oil per liter	1.35	44.4	71.7	61%
Teff per kg	1.16	22.0	23.9	9%
Barley per kg	0.65	13.2	16.5	25%
Beer	0.5	12.9	14.3	10%
Mineral water	0.1	9.2	10.0	8%
Consumer Goods				
Laundry Soap (local)	1.07	8.6	10.5	23%
Jeans	0.83	408	473	16%
Laundry Soap (Imported)	0.78	10.8	12.2	13%
T-shirt	0.17	203	247	22%
Table	0.17	1,949	2,467	27%
Chair	0.17	824	1,008	22%
Service items				
House rent (two bedroom)	3.26	1,067	1,127	6%
Health (per doctor visit)	0.69	16	18	9%
Education	0.45	296	334	13%
Cost of tailoring	0.33	797	888	11%
Airplane (Trip to Addis)	0.28	1,662	1,730	4%
Ship and Boat transport	0.15	12.5	15.0	20%
Bus Fare	0.15	0.4	0.4	3%
Theater entrance	0.11	33	53	61%
Hotels (per room)	0.10	160	163	2%
Utilities, Fuel, Miscellaneous				
Fuel, per liter	3.11	16.5	18.9	14.9%
Water, cubic meter	1.66	4.0	4.4	8.7%
Telecom, per minute	1.22	0.5	0.5	8.2%
Electricity, per kilowatt	0.46	0.3	0.3	0.0%
Cement	0.2	133	139.8	5%
Postal service	0.1	10.6	10.9	3.1%
Postal service/fast	0.1	39.8	61.0	53%
Sand	0.1	317	326.0	3%

Source: CSA price level data for September 2018 inflation

Outlook

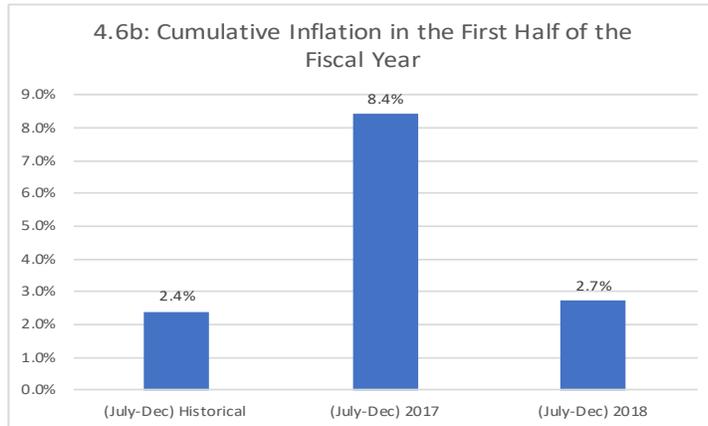
The outlook for inflation this year shows a mixed picture. Upward pressures on prices appear likely in areas such as transport costs (reflecting recent fuel price adjustments after nearly a year of unchanged prices), electricity tariffs, as well as in rental costs in governmental and private commercial and residential rates (for which press reports indicate significant increases in recent months). At the same time, downward or moderating price pressures are likely for food, given the record crop harvest and the continued expectation for administratively set price for key staples such as wheat, sugar, and edible oil. The latter three food items, which are subsidized by government and imported mainly via bulk government purchases, should benefit from flat to only slightly higher prices for 2019 based on IMF projections, suggesting limited inflation pressures from imported food prices. Finally, macro policies will not add upward pressure to prices in our view, as: (1) the government’s budget deficit is being reduced somewhat from last year; (2) the central bank has committed to a tighter monetary growth program for the year per indications in the IMF’s recent Article IV staff report (only 13 percent reserve money growth this year, vs 23 percent two years ago and 19 percent last year); and (3) broader monetary growth, judging by July-September banking data, has slowed somewhat in the first quarter of the fiscal year relative to year ago levels (both deposit and loan growth are expected to be lower this year compared to recent years; see Chapter 7).

Focusing on inflation outturns since the start of the current fiscal year, price pressures are seen to be moderating, despite a slight uptick in December 2018. Cumulative inflation for the six months since the start of the fiscal year (July-December 2018) has been only 2.7 percent, while the first six months of the previous fiscal year showed 8.4 percent inflation by end-December 2017. In addition, looking at the most recent period, month-on-month inflation has turned negative for two of the past three months, in line with monthly inflation patterns over the past 25 years shows the last three months of the calendar year typically record negative month-on-month inflation of around 0.5 percent, reflecting food price developments following seasonal harvests. In 2018, month-on-month inflation for October, November, December was -0.31, -1.09, and +1.5 percent respectively, with the increase seen in December appearing to reflect the recent 8 percent fuel price adjustment.



Source: CSA

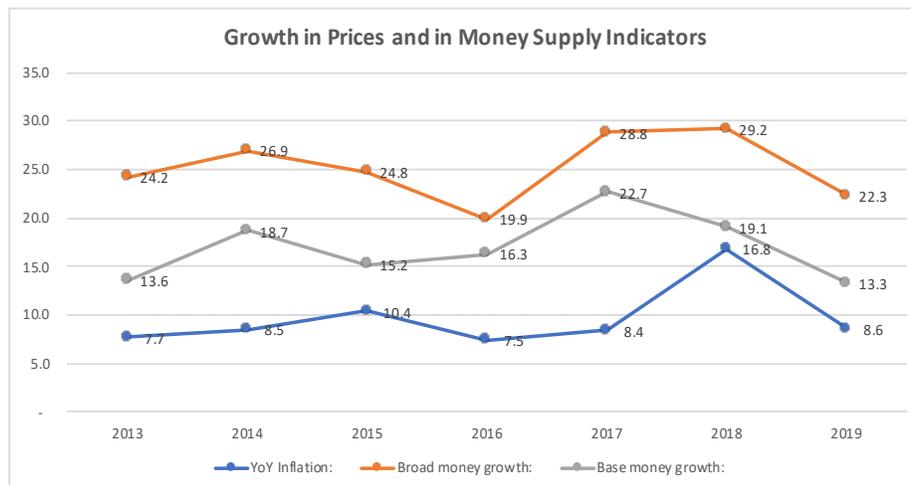
TABLE 4.6: Cumulative Inflation in First Half of the Fiscal Year



Source: CSA

Taken all together, we forecast inflation will fall to a single-digit level of 9 percent by end-March 2019, and remain within 1-2 percentage points of that level (plus or minus) for the remainder of the year. We don't see inflation showing any material decline below 9 percent for the rest of 2019, as the negative month-on-month inflation rates of the last quarter of the calendar year reverse in the January-March period and in subsequent quarters. Reflecting the above, we expect inflation will not be far from the double-digit threshold for most of the year, and project year-on-year inflation at 8.6 percent as of June 2019 and just under 10 percent as of December 2019.

Table 4.7: Growth in Prices and in Monetary Variables



Source: CSA, NBE and Cepheus Research for projections

Table 4.8: Inflation Projections to end-2019

	Price index	M-o-M inflation	Y-o-Y inflation
<i>Actuals</i>			
June 2018	125.2	2.3%	16.8%
July 2018	126.7	1.2%	15.3%
August 2018	127.1	0.3%	14.2%
September 2018	128.5	1.1%	11.8%
October 2018	128.1	-0.3%	12.2%
November 2018	126.7	-1.1%	9.1%
December 2018	128.6	1.5%	10.4%
<i>Projections</i>			
January 2019	129.6	0.8%	10.1%
February 2019	130.7	0.8%	10.5%
March 2019	132.0	1.0%	9.4%
April 2019	133.3	1.0%	10.3%
May 2019	134.6	1.0%	10.0%
June 2019	136.0	1.0%	8.6%
July 2019	138.2	1.6%	9.1%
August 2019	139.2	0.8%	9.5%
September 2019	142.2	2.1%	10.6%
October 2019	141.6	-0.4%	10.5%
November 2019	141.1	-0.4%	11.3%
December 2019	141.2	0.1%	9.8%

Source: Cepheus Research

5. Have debt levels become worrisome?

Key points

- Ethiopia’s public-sector debt-to-GDP ratio of near 60 percent is not out-of-line with the norm seen in many African countries, and its composition shows that roughly half of the total is in the form of low-cost domestic debt. At the same time, repayments on external debt have reached \$1.5bn per year and thus become quite high relative to reserves and to exports. Ethiopia’s public sector is thus currently facing more of a debt servicing challenge—linked to several years of weak exports and a bunching up of repayment dues—rather than a debt sustainability problem.
- Private debt is only around 17 percent of GDP, or less than one-third the size of public debt; while the latter has limited scope for growth, there is plenty of room to grow for the former.
- For the first time ever, foreign equity inflows (FDI) surpassed foreign debt inflows in 2017 and this was repeated again in 2018. The increasing substitution of equity with debt should ease debt sustainability going forward even if goods exports don’t pick up as fast as expected. Rising remittances and grants—both of which should get a lift from recent reforms—will further ease debt concerns.

Ethiopia’s public sector debt has risen 16.5x in the past decade, reaching Birr 1.3 trillion as of June 2018 from Birr 371bn five years ago and Birr 80 bn ten years ago. Expressed in USD terms, public sector debt has reached \$48bn as of June 2018, up from \$19.9bn five years ago and \$8.3bn a decade ago. This total public debt figure includes borrowing from external and domestic lenders and also covers the debt of both government and state enterprises. As of mid-2018, slightly more than half of public sector debt was owed to external lenders (\$25.9bn or around Birr 706bn) while the remainder was debt owed to domestic lenders, mostly to the state-owned commercial bank and pension funds. A summary of this increase, by public sector entity (central government vs state enterprises) and by lender (foreign vs domestic) is presented in Table 5.1.

Table 5.1: Public Debt as of June 2018					
	Birr bns	USD bns	% GDP	% Total	
Public Sector Debt	1,318	\$ 48.4	58%	...	
External Debt	706	\$ 25.9	31%	100%	
Owed by Federal Government	402	\$ 14.7	18%	57%	
Owed by State Enterprises	305	\$ 11.2	13%	43%	
Domestic Debt	612	\$ 22.5	27%	100%	
Owed by Federal Government	298	\$ 10.9	13%	49%	
Owed by State Enterprises	314	\$ 11.5	14%	51%	

Source: MoFEC

Within the public sector, both the federal government and state enterprises have accumulated debt at a roughly equal pace over the past five years. Central government debt rose nearly two-fold in the past five years, from \$13.9bn to \$25.8bn, while state enterprises showed a nearly identical doubling of debt levels from \$11.9bn to \$22.8bn. By borrowing sources, domestic debt accumulation (1.9x in the last five years) was slightly higher than external debt accumulation (1.8x over the same period). A snapshot of the trends in the public sector debt accumulation by entity and by source is provided in Table 5.2.

	2013/14	2014/15	2015/16	2016/17	2017/18
Total Public Debt	\$ 25.8	\$ 33.5	\$ 38.6	\$ 45.1	\$ 48.6
<i>By borrower:</i>					
Government	\$ 13.9	\$ 16.7	\$ 19.3	\$ 23.3	\$ 25.8
State Owned Enterprises	\$ 11.9	\$ 16.8	\$ 19.4	\$ 21.8	\$ 22.8
<i>By source:</i>					
Domestic debt	\$ 11.7	\$ 14.9	\$ 17.3	\$ 21.7	\$ 22.7
External debt	\$ 14.1	\$ 18.7	\$ 21.3	\$ 23.4	\$ 25.9

Source: MoFEC

Though the nominal increases in public sector debt are substantial, with nominal GDP increasing nine-fold over the past ten years (from Birr 245bn to Birr 2,202bn), Ethiopia’s debt-to-GDP is not out of line with the seen norm in many African countries or emerging market economies. The total public-debt to GDP ratio of around 58 percent is nearly identical to the 56 percent average seen for all African countries (excluding Nigeria and South Africa) and not that different from ratios seen in countries such as Kenya (56%), South Africa (55%), Vietnam (58%), and Mexico (54%). Finally, looking at the ratio of the NPV of debt to GDP—the more relevant ratio for a country that has a lot of concessional debt—one sees an even better picture (just 50 percent of GDP) than suggested by the simple nominal debt to GDP ratios (see the IMF’s December 2018 Debt Sustainability Assessment). The fact that about half of public sector debt is secured from low-cost domestic debt (unusual among most African and emerging market economies and possible thanks to state-directed financial sector policies) further limits the country’s overall public sector debt burden.

Table 5.3 Total Public Debt: Cross-Country Perspective FY 2018

	Total Debt (bn USD)	Total debt (% GDP)
Africa		
Ethiopia	\$ 48.37	57.6%
Kenya	\$ 50.21	56.1%
Tanzania	\$ 20.81	37.4%
Ghana	\$ 36.88	71.2%
Senegal	\$ 12.22	50.4%
Nigeria	\$ 98.57	24.8%
South Africa	\$ 209.81	55.7%
Egypt	\$ 230.81	92.5%
Africa avg	\$ 88.46	55.7%
Asia		
Brunei Darussalam	\$ 0.35	2.4%
Cambodia	\$ 7.65	31.7%
Indonesia	\$ 300.98	29.8%
Laos	\$ 12.16	66.7%
Malaysia	\$ 191.36	55.1%
Myanmar	\$ 23.75	33.2%
Philippines	\$ 132.01	39.8%
Singapore	\$ 391.33	112.9%
Thailand	\$ 205.36	41.9%
Vietnam	\$ 139.55	57.8%
Asia avg	\$ 140.45	47.1%
Latin America		
Brazil	\$ 1,688.4	88.4%
Mexico	\$ 645.6	53.8%
Colombia	\$ 164.1	48.7%
Peru	\$ 60.4	26.4%
Costarica	\$ 32.7	53.7%
Guatamala	\$ 19.9	25.1%
EL salvator	\$ 17.6	67.9%
Honduras	\$ 9.5	39.7%
Barbados	\$ 6.4	123.6%
Nicaragua	\$ 5.0	37.5%
Latam avg	\$ 265.0	56.5%

Source: IMF (World Economic Outlook)

While debt-to-GDP ratios thus do not stand out when compared to peers, one part of the debt increase that has become comparatively high is the external debt stock when seen relative to exports (a measure of all future repayment obligations) as well as the annual principal and interest repayments relative to exports (a measure of current debt servicing burdens). Focusing just on external public sector debt, annual debt service dues have risen from USD 77mn ten years ago to USD 666mn five years ago and USD 1,530 mn for the year that ended in June 2018. The corresponding debt-to-exports figure has jumped substantially, from 8.5 percent to 18.3 percent to 24 percent over this period, even using an export denominator that includes both goods and services exports. The size of the public sector external debt stock relative to foreign reserves has also risen sharply, from 2.9x a decade ago to 4.7x five years ago and 8.6x as of June 2018. It is largely this deterioration in ratios of debt repayment capacity that has been behind the change in the country's debt burden assessment by the IMF, which in January 2018 and December 2018 concluded their debt sustainability assessment with a "high risk" of debt distress as Ethiopia exceeded the applicable thresholds of 180 percent for debt-to-exports and 20 percent for debt service-to-exports.

Table 5.4: External Public Debt Service Repayments

	2013-14	2014-15	2015-16	2016-17	2017-18
External debt service due: USD mns	\$ 667	\$ 993	\$ 1,140	\$ 1,288	\$ 1,530
<i>External debt repayments in percent of:</i>					
Exports of goods and services	10.3%	16.4%	18.8%	20.6%	21.7%
Foreign exchange reserves	26.7%	30.6%	33.5%	40.3%	51.1%
Exports of g&s plus remittances	7.1%	10.1%	10.9%	12.1%	12.6%
Current account receipts	5.6%	8.0%	8.2%	9.8%	10.7%
Memo items: USD mns					
Exports of goods	\$ 3,300	\$ 3,019	\$ 2,868	\$ 2,908	\$ 2,840
Exports of services	\$ 3,174	\$ 3,028	\$ 3,196	\$ 3,331	\$ 4,220
Exports of goods & services	\$ 6,474	\$ 6,047	\$ 6,064	\$ 6,239	\$ 7,059
Reserves	\$ 2,496	\$ 3,249	\$ 3,402	\$ 3,197	\$ 2,996
Remittances	\$ 2,968	\$ 3,797	\$ 4,420	\$ 4,428	\$ 5,121
Exports of g&s plus remittances	\$ 9,442	\$ 9,844	\$ 10,484	\$ 10,666	\$ 12,181
Current account receipts	\$ 11,974	\$ 12,437	\$ 13,884	\$ 13,152	\$ 14,360

Source: Cepheus Research estimates for debt service ratios based on NBE and MoFEC data

Outlook

Looking ahead, and given recent reforms, will the debt burden become a major impediment that holds back growth? We think not, as several very recent initiatives point to a moderation in *new* debt accumulation and since we also forecast a strengthening of the country's capacity to service external debt (i.e., debt ratios will benefit from a slower increase in the numerator and a large expansion in the denominator). As nominal GDP should continue growing strongly (by near 20 percent per year in nominal Birr terms and close to 10 percent per year in USD terms even with some annual depreciation), this allows for some continued debt accumulation without a deterioration in debt-to-GDP ratios. Indeed, debt of around \$2bn to \$3bn on its own does not worsen debt-to-GDP ratios given the rise in

the dollar GDP denominator. But in any case, new debt accumulation will be moderated on account of large-scale privatization, a shift towards use of PPPs in large infrastructure projects, and the avoidance of borrowing on non-concessional terms (i.e., at market interest rates).

Regarding debt servicing capacity, the combination of recent reforms and some recent bilateral agreements have limited near-term risks in this area. Most notably, temporary financing has been secured to boost reserves from bilateral sources while a rescheduling of Chinese debt has reportedly stretched out near-term repayments over 30 years.¹⁰ But perhaps most important, the advent of broader reforms in Ethiopia has boosted remittance inflows sharply this year: data to June 2018 showed remittance inflows up 16 percent from the year before and annual inflows of \$5bn, while the state banks (the largest conduit for remittance flows) has recently reported a record \$ 1bn remittance inflows for the first quarter of the current fiscal year. Indeed, including remittance inflows, debt servicing capacity does not at all present serious risks, but remittances are *not* included in the calculation of the IMF's debt distress ratings, and accordingly debt service ratios (based on debt-service to exports of goods and services) reached 24 percent for the coming fiscal year and triggered a "high risk" of debt distress rating. With the inclusion of remittances, this ratio falls to 13 percent, a manageable level and one that would qualify for a moderate rating.¹¹

Moving beyond the public sector, the size of Ethiopia's private sector debt levels are worth noting, as these are still comparatively low and show plenty of room to grow. Ethiopia's private sector credit to GDP ratio is still at a low base and can easily grow by over 30 percent per year over the coming years.

- **Private debt owed to domestic lenders:** The total borrowing of private firms and households from the banking system is currently Birr 328bn billion, up nearly three-fold from five years ago. (Table 5.5). This figure of Birr 328bn is part of Birr 1,056bn in total domestic debt of government, state enterprises and the private sector, pointing to a one-third share of the private sector in total domestic credit. Relative to GDP, private sector debt stands at just 17 percent and the number of borrowers in the banking system (currently only around 250,000) remains low—both of which point to large scope for future growth. The NPL ratio at private banks (the source of most private debt) is around 2-3 percent, suggesting negligible debt burdens for private borrowers in the aggregate. From a cross-country perspective, private sector credit-to-GDP is in the 40-50 percent range in many other African countries (including Kenya, Ghana, Nigeria, and Egypt) which provides further indication of the large room for expansion in this area.
- **Private sector debt owed to foreign lenders:** In recent years, private firms have increasingly been able to borrow from abroad, especially with a more flexible policy by the central bank to

¹⁰ The IMF's December 2018 Article IV paper reports \$1bn in foreign exchange deposits placed at the NBE from the UAE, while press reports from September 2018 indicate a rescheduling of \$4bn in railway-related Chinese loans, with maturities stretched out from 10 to 30 years (a large savings in NPV terms based on some reasonable assumption for discount rates).

¹¹ The inclusion of remittances is as justified as including services exports in the basis for using repayment capacity—both are recurring current accounts inflow that provide fx resources to help meet annual principal and interest obligations.

allow such private borrowing in the case of exporters, large domestic corporates, and foreign companies. Within the past year, suppliers’ credits from foreign sellers have also been accommodated more generously to assist companies in securing key raw materials or equipment. The size of foreign borrowing by private sector companies (judging by the difference between total external debt and public debt reported in the IMF’s debt sustainability reports) has gone up from \$1.7bn to \$2.1bn in the past five years, and is now close to 2.5 percent of GDP. At Birr 55bn when expressed in local currency terms, the amount of foreign debt taken on by the private sector is thus already around one-seventh of total private sector debt of Birr 385bn. Most of this private external debt is likely to be facing market interest rates, but this should not pose serious risks as the financing secured by the borrowing companies is typically for growth and expansion capital, allowing them to cover repayments over time.

Table 5.5: Trends in Private Debt

Birr bns	2013-14	2014-15	2015-16	2016-17	2017-18
Total Private Debt	163	217	252	303	385
From Banks	115	147	179	231	284
From MFIs	17	22	25	32	45
From Foreign Lenders	32	48	48	40	55
Total Private Debt-to-GDP	15%	17%	16%	17%	17%
Total Private Debt-to-Total Debt	23%	22%	21%	21%	21%
Total Public and Private Debt	711.1	973.9	1,173.6	1,425.6	1,818.4
GDP, Birr bns	1,061	1,298	1,568	1,833	2,202

Source: NBE and IMF Debt Sustainability Analysis

In sum, with a slowdown in state enterprise borrowing plus strong prospects for a balance of payments improvement on the back of large privatizations and a set of more orthodox macroeconomic reforms, the picture that emerges is of an improving debt and debt servicing outlook. As elaborated above, our view is that thanks to the current set of macro/structural reforms being put in place and in light of the gradual projected improvements in fx inflows, key debt and debt-servicing ratios are broadly manageable. Perhaps the strongest indicator of this is that both *market assessments* and *forward-looking indicators* of Ethiopia’s debt position do not suggest any serious concerns in this area: the three global ratings (Standard and Poor’s, Fitch, and Moody’s) agencies have maintained their B/B/B1 ratings for Ethiopia throughout 2017 and 2018, while Ethiopia’s sovereign bond—the country’s only such instrument traded in global capital markets— has not shown a widening of spreads beyond what was seen for emerging markets as a whole in 2018.¹²

¹² Yields on Ethiopia’s sovereign bond have risen to 6.9 percent as of end-2018, up from around 5.7-5.9 percent at end-2017. However, this 1 percentage-point increase in is in line with the yield increases seen for emerging markets in 2018 and does not show any increased Ethiopia-specific risk assessment by the holders of Ethiopia’s sovereign bonds. A yield of 6.9 percent (effectively the interest rate that Ethiopia would face if borrowing from global capital markets at this time) is also

6. Can savings continue to rise?

Key points

- **Bank deposits have risen 12-fold over the past decade, from just Birr 63bn to Birr 730bn, propelled by major branch expansions and several national savings schemes. Relative to the size of the economy, total deposits at banks are now 33 percent of GDP and, excluding checking accounts, savings deposits alone are 21 percent of GDP.**
- **As measured in the national accounts, domestic savings is now 24 percent of GDP, up from 18 percent of GDP five years ago and 9 percent a decade ago. Of total domestic savings, around 97 percent is contributed by the private sector, per IMF breakdowns. Despite limited per capita incomes, large segments of the population have thus been able to sacrifice substantial shares (almost a quarter) of their incomes.**
- **Looking ahead, expecting higher savings rates from the private sector may no longer be feasible or desirable. The scope for boosting private domestic savings, at least relative to GDP, may also be limited in other ways: cash circulating outside banks is not very significant from a macro perspective and recent savings schemes can no longer benefit from one-off gains (such as the start of the private pension scheme). Given all this, sustaining a high investment rate will only be possible by boosting savings from the *public sector* and/or from *foreign sources*.**

Financial savings as measured by bank deposits have shown a dramatic expansion over the past decade—though more so in nominal terms rather than relative to GDP. Key metrics illustrating this increase are shown in Table 6.1 below, showing most notably that, over a ten year time-frame, bank deposits are up 11.6-fold (from Birr 63 billion to 730 bn, or from 26 to 33 percent of GDP), bank branches are up 8.5-fold (from 562 to 4,757), and the number of depositors is up 9.5-fold (from 3.5 million to 33.4 million). The rise in domestic savings has been driven by a combination of factors that include geographical expansion of bank branches (around 3,080 of the 4,757 branches are outside the capital city); aggressive bank mobilization efforts; public and private pension savings schemes; housing savings schemes; and other public savings schemes such as those for the Grand Ethiopian Renaissance Dam.

still quite favorable when seen against end-2018 yields for USD bonds of sovereigns such as Kenya (7.9%), Egypt (7.4%), Namibia (7.4%), Senegal (7.2%), and South Africa (6.9%).

Table 6.1: Financial Savings

Domestic financial savings measures--Birr bns	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
Commercial Bank Deposits	237	293	367	438	569	730
MFI Deposits	12	17	23	27	37	47
NBE funds (incl currency)	146	170	210	262	290	341
DBE funds	30	38	44	53	57	84
Pension Fund assets	26	32	42	57	73	111
Domestic Financial Sources	451	550	685	837	1,026	1,314
Domestic financial savings measures--% GDP	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
Commercial Bank Deposits	27%	28%	28%	28%	31%	33%
MFI Deposits	1%	2%	2%	2%	2%	2%
NBE funds	17%	16%	16%	17%	16%	16%
DBE funds	3%	4%	3%	3%	3%	4%
Pension Fund assets	3%	3%	3%	4%	4%	5%
Domestic Financial Sources	52%	52%	53%	53%	56%	60%
Other measures of financial savings	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
Bank branches	1,728	2,208	2,693	3,301	4,257	4,757
<i>Of which: CBE</i>	837	971	1,097	1,150	1,310	1,375
<i>Of which: DBE</i>	32	32	32	110	110	107
<i>Of which: Private banks</i>	859	1,205	1,564	2,041	2,837	3,275
Depositor numbers (mns)	10.22	13.05	16.53	20.33	26.65	33.52
GDP (Birr bns)	867	1,061	1,298	1,568	1,833	2,202

Source: NBE

The decomposition of the sources of deposit growth shows that the private sector has been and remains the largest contributor, making up 75 percent of total deposits in the banking system. The private sector's deposits have become more important over the past ten years (it is up somewhat from a 70 percent share in 2008), thus contributing importantly in the domestic savings build-up. The second largest saving contributors—as measured by bank deposits—are public enterprises/agencies (whose share is up from 8 to 12 percent over the last ten years), while government deposits make up the third largest share at 8 percent of deposits in the banking system as of June 2018.

Table 6.2: Deposit Trends over the Past Decade, by Saver (In millions of Birr)

Particulars	Jun-08	Jun-13	Jun-14	Jun-15	Jun-16	Jun-17	Jun-18
Government	8,978	39,112	39,211	47,598	48,275	57,432	60,391
Public Agencies and Enterprises	5,072	28,068	32,112	33,947	39,335	56,324	90,926
Private and Cooperatives	43,408	154,991	203,511	266,040	328,317	426,231	544,991
Domestic Commercial Banks	483	1,222	2,175	3,127	3,080	4,365	6,428
Domestic Non-Bank Financial Agencies	1,565	4,719	5,897	6,930	6,913	11,495	10,709
NR-Accounts	2,949	8,358	8,941	9,188	10,816	11,871	15,607
Total	62,456	236,470	291,846	366,830	436,736	567,717	729,051

Source: NBE

The growth in savings as measured by banking deposits is broadly reflected in other monetary figures and in national accounts savings data, though with some notable variance in magnitudes involved. Money supply—which is comprised of currency in circulation plus deposits and alternatively known as broad money—is up from Birr 68bn to 741 bn between 2008 and 2018 (a 10.6x increase), or from 28 to 34 percent over the same period when expressed relative to GDP. This is roughly in line with the rise in banking sector deposits, which are up from 26 to 33 percent when expressed relative to GDP. These shifts suggest some financial deepening, but not to a substantial degree. However, national accounts data for domestic savings, point to a much sharper increase that suggests a jump in savings (if well-measured) from a very low of 9 percent of GDP ten years ago to around 18 percent of GDP five years ago and 24 percent of GDP in FY 2017-18. In addition, per the IMF breakdown of national accounts-based savings figures (see Article IV Report), most of Ethiopia’s domestic savings—97 percent—represents private as opposed to public sector savings.

Cash circulating outside the banking system has fallen sharply relative to GDP, further suggesting a greater placement of funds at banks rather than ‘under mattresses’. Trends in currency with the public show a decline over the past ten years, from 7 percent of GDP to 4 percent of GDP and from 17 to 9 percent of total banking sector assets. While this would (in other countries) often reflect a move to digital/electronic payments, given that this space is still in its infancy in Ethiopia, we take the decline in the relative share of the public’s cash holdings as an indication that most funds not needed for daily transactions have increasingly been absorbed as deposits by the banking system. At 4 percent of GDP, cash in public circulation is in line with amounts that would be reasonably be expected to be held for day-to-day transactional purposes.

Outlook

While the overall record of deposit mobilization and financial deepening has thus been broadly positive and impressive, the scope for future expansion in domestic savings (relative to GDP) is likely to be much more constrained. In particular, some of the contributing factors that propelled past savings increases cannot be fully replicated and, in any case, it may not be desirable to push for significantly more *private sector* savings beyond the high level (24 percent of GDP) now suggested by national income statistics. Elaborating further on these points:

- **Private savings have likely plateaued:** Given the already big jump in domestic savings rates relative to GDP, we expect that a further expansion relative to GDP will be difficult to achieve for several reasons. As noted above, currency outside the banking system (i.e., funds not yet captured for bank intermediation) is at low levels and this suggests limited room for extra gains by geographic or aggressive bank-based expansion. In addition, part of the boost to recent savings is unlikely to yield as much gains as in the past, since it partly reflected one-off gains (such as getting all private employees to join into a pension scheme) or exceptional fund-raising schemes for high-profile mega-projects. Others saving schemes—such as for public condominiums—could also produce slower gains to the extent that the delivery record on these

projects has lagged in recent years, discouraging current and future savers. Thus, while private savings could continue to increase in nominal terms (by as much as 10-15 percent per year) alongside rising incomes, this will not show up as a rise relative to GDP given nominal GDP growth rates of 20-plus percent on an annual basis.

- **Consumption vs Saving:** In terms of the feasibility of further boosting savings relative to GDP, expecting the private sector—already saving a quarter of its income—to sacrifice further consumption could become increasingly unrealistic. At Ethiopia’s low average per capita income levels, a 24 percent savings rate is already a high achievement and sacrificing a such a material share of income for savings is not common among countries with similar income levels.

With domestic savings thus constrained for the coming years, and likely to remain flat (or fall somewhat) as a share of GDP, what other sources of financial savings could maintain high investment and high growth? The alternatives are domestic public sector saving and/or foreign resources/savings. The former would not provide much incremental resources, in our view, given the challenges of maintaining a primary budget surplus in the current economic environment and the likelihood that any potential gains in revenue mobilization in the coming years will most likely flow into equivalent increases in recurrent public spending. The most promising prospect must thus be taken to lie with external savings, or financial resources from the rest of the world in all their forms: remittances, private grants, official grants, FDI, and loans. In the most recent fiscal year, the inflows of such foreign savings were down to around 10 percent of GDP, judging by the gap between investment and domestic savings reported in FY 2017-18 GDP statistics. This figure could realistically rise to 13-15 percent of GDP or more with substantially higher inflows from several of the external resources itemized above. Indeed, based again on national income accounts, foreign savings was as high as 15-18 percent of GDP in Ethiopia looking back five and ten years ago (reflecting proportionally higher external transfers and a much smaller GDP), but this ratio has fallen sharply over time and the burden of covering domestic investment was thus carried increasingly by domestic savings. Just partially reversing this trend in the use of foreign resources/savings (i.e., moving its ratio towards the mid-teens relative to GDP) and—importantly—making greater use of private transfers and equity rather than primarily debt inflows could thus provide incremental savings of 3 to 5 percent of GDP, allowing for continued high investment rates without sacrificing either growth of domestic consumption.

Table 6.3: Deposit Trends over the Past Decade, by Institution (In millions of Birr)

Birr mns	Jun-08	Jun-13	Jun-14	Jun-15	Jun-16	Jun-17	Jun-18
Commercial Bank of Ethiopia	40.3	159.8	199.6	248.3	289.6	366.0	453.0
Private Banks	22.2	76.7	92.3	118.3	147.1	201.7	276.0
Total	62.5	236.5	291.8	366.6	436.7	567.7	729.1
Percent of total deposits							
Commercial Bank of Ethiopia	64%	68%	68%	68%	66%	64%	62%
Private Banks	36%	32%	32%	32%	34%	36%	38%
Total	100%	100%	100%	100%	100%	100%	100%
Percent of GDP							
Commercial Bank of Ethiopia	18.6%	27.3%	27.5%	28.2%	27.9%	31.0%	33.1%
Private Banks	12.0%	18.4%	18.8%	19.1%	18.5%	20.0%	20.6%
Private Banks	6.6%	8.8%	8.7%	9.1%	9.4%	11.0%	12.5%

Source: NBE and private banks reports

Table 6.4: Trends in Investment and its Domestic vs External Financing Sources

	2015/16	2016/17	2017/18	Projection	
				2018/19	2019/20
Total Investment--Birr bns	586	705	752	921	1,142
Financed by Domestic Savings	351	410	535	641	720
Financed by External Resources	234	295	216	280	422
Total Investment--% GDP	37.3%	38.4%	34.1%	34.5%	36.5%
Financed by Domestic Savings	22.4%	22.4%	24.3%	24.0%	23.0%
Financed by External Resources	14.9%	16.1%	9.8%	10.5%	13.5%

Source: NBE

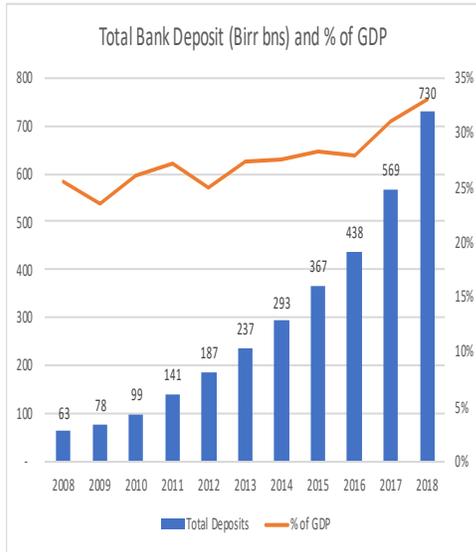
7. Will banking keep booming?

Key points

- **The banking sector has been in the midst of a booming environment for the past decade, marked by 28 percent annual deposit growth, 31 percent annual lending growth, 22 percent annual profit growth, and shareholder returns—at private banks—that averaged 33 percent per year during this period.**
- **High growth and high profits were driven in part by the fast-growing macroeconomy, but also reflected favorable (for the banks) net interest margins, fx-related fees, and cost-to-income ratios. Despite some likely pressure on these operational metrics in the coming years, we project that the profit pool of Ethiopian banks will soon reach close to \$1 billion (around Birr 28bn), while average earnings per share will fall somewhat but remain above 25 percent per year, by our calculations.**
- **Growth opportunities for Ethiopian banks will come from moves into untapped funding sources (bank bond issues, foreign borrowing), untapped lending spaces (consumer lending, credit cards, SME loans), digital products and payments, and capital markets related services when reforms in this area eventually bring bond and equity markets. All of the above would boost financial access and inclusion, while enabling the sector to serve as a well-functioning ‘circulatory system’ needed for a private-sector driven economy.**

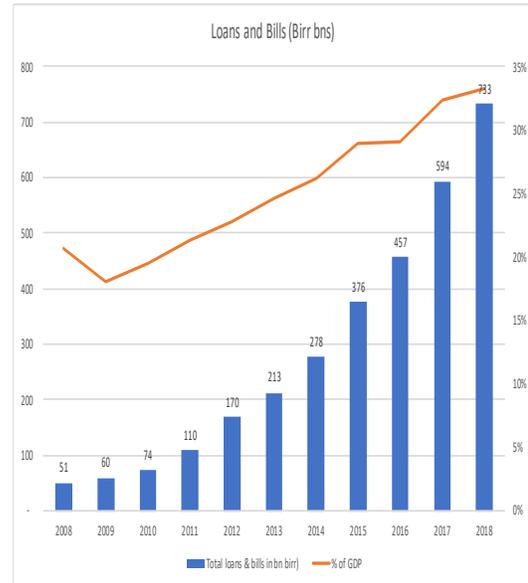
The banking sector has shown strong deposit, lending, capital, and profit growth without almost any interruption for the past 20 years. Key elements of this growth are documented below for the past ten years, revealing a 11.6x rise in deposits, a 14.4x rise in loans, a 8.7x rise in capital, and 6.7x rise in profits over the past decade. The pace of growth between public and private banks has been broadly similar, though the latter have taken a somewhat larger share in deposits (from 32 to 38 percent) over the past five years. Though nominal growth in these banking metrics is impressive, it is worth noting that with GDP growth also quite high in the Ethiopian context, the overall size of banking assets to GDP has risen more moderately from 44 to 45 percent over the past decade. Over the same period, deposits are up from 26 to 33 percent of GDP, total credit is up from 21 to 33 percent of GDP, and banks’ capital is largely unchanged, declining from 4.0 to 3.9 percent of GDP.

Table 7.1a: Total Bank Deposits (Birr bns) and % of GDP



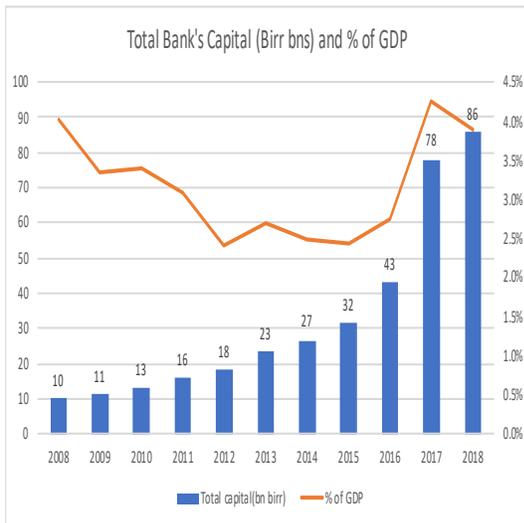
Source: NBE

Table 7.1b: Total Loans and Bills (Birr bns)



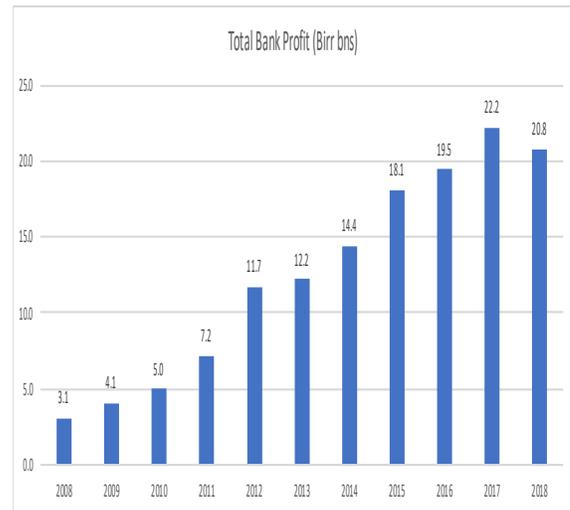
Source: NBE & Banks annual reports

Table 7.1c: Total Bank's Capital (Birr bns) and % of GDP



Source: NBE and banks annual reports

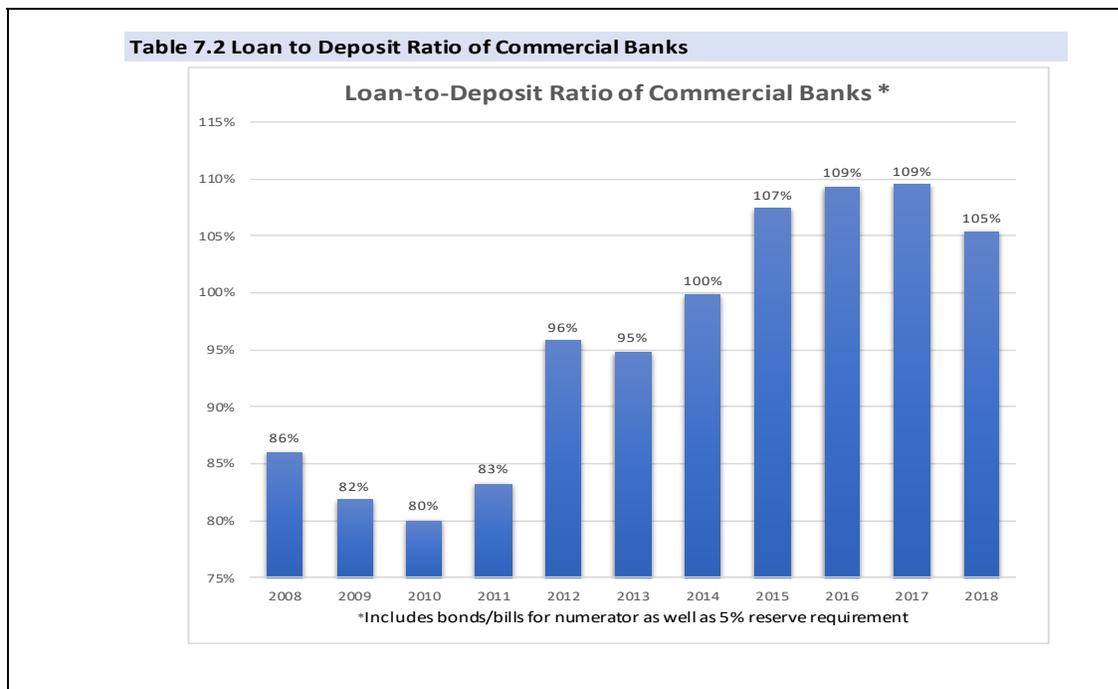
Table 7.1d: Total Bank Profit (Birr bns)



Source: Banks annual reports

Driving banks’ impressive growth has been their ability to gather and deploy two key financial resources—public deposits and foreign exchange. On deposits, public and private banks have collectively raised their branch network from 562 ten years ago and 2,208 five years ago to 4,757 branches as of June 2018. In parallel with the rising deposits, depositor numbers have jumped from 4 million in 2010 to 10 million five years ago to 33 million today—equivalent to perhaps on one half of the *adult* population. CBE alone has mobilized 15 million customers through a service network that covers virtually all corners of the country (1,375 branches, 1,708 ATMs, and 11,796 POS machines) and multiple user channels (4.4 million card users and 1.7 million mobile banking customers). The expanding reach of banks is also seen among the private banks, with some of the largest private banks each now surpassing a network of over 380 branches, 2 million customers, above 300 ATMs, nearly 1,000 POS devices, and above 700,000 card users.

For a given stock of mobilized resources, Ethiopian banks have stood out for being able to effectively deploy virtually all of these resources given an environment of high demand for credit and foreign exchange. In recent years, the loan-to-deposit ratio at banks reached as high as 109 percent, after accounting for the 5 percent mandatory reserve requirement and the bond/bill holdings of CBE and private banks. (The loan-to-deposit ratio can exceed 100 percent since banks can also lend out some portion of their capital base). On the foreign exchange side, all mobilized foreign exchange funds are able to be sold immediately given excess demand for foreign exchange and, precisely for this reason, inter-bank foreign exchange trading is virtually non-existent among banks as sales to end-customers can be immediately effected. The ability to quickly intermediate mobilized resources has thus been one key basis for banks’ strong growth.



Source: Banks annual report

Looking more broadly at the sources of banks' high growth and high profits, this has also reflected key operational ratios that have worked in banks' favour for many years. The three most relevant operational metrics in this context have been banks' net interest margins, fx-related fees, and cost-to-income ratios.

- **Net interest margins:** With average lending rates at 11.9 percent and average deposit rates at 4.5 percent, banks enjoy a spread of around 7.5 percent on average. The high lending rate reflects average loan rates of 14-18 percent for most (non-export) loans and rates of 8.5-10 percent for export or priority customers. On the deposit side, despite a minimum 7 percent interest rate that must be paid on savings deposits, the effective deposit rate paid by banks on their total deposits is actually 4.5 percent given their ability to attract non-interest paying accounts (checking deposits), which in 2017-18 comprised on average 27 percent of total deposits across private banks. For each Birr 1 billion in deposits mobilized, banks thus stand to earn as much as Birr 75 million in net interest income (though this is reduced by a 5 percent reserve requirement on deposits and the mandatory purchase of NBE Bills for 27 percent of gross loan disbursements).
- **Fx intermediation fees:** Fees for opening Letters of Credits (L/Cs), which averaged 1 to 2 percent at most private banks about ten years ago, and 3 to 4 percent five years ago, are now between 6 and 7.5 percent at most private banks. Such fees are exceptionally high in a cross-country context, with the banks' high pricing power arising due to tight fx conditions and excess demand for foreign exchange. Thus, on the fx side of banks business, for each USD 100 million in foreign exchange inflows collected from customers, banks stand to earn nearly Birr 200 million in non-interest revenue (though this is again reduced somewhat by regulatory requirements that call for a surrender of 30 percent of fx inflows to the central bank).
- **Cost-to-income ratios:** Low employee costs (especially when put in a global/regional context), the use of typically simple branch facilities, limited IT expenses for most of the past ten years, and low NPLs/provisions have collectively allowed banks to maintain low cost-to-income ratios of just 41 percent in recent years, compared to the 60-65 percent ratio seen in most other African and emerging market economies.

Taking into account the key operational metrics of banks more formally (via a Dupont Analysis), one observes that the biggest source of profitability has been provided by high net interest margins, reflecting in part the traditional dominance of credit intermediation activities at Ethiopian banks. For the sector as a whole, net interest income was—for 2018—a high 4.9 percent of assets while non-interest revenue was just 3.7 percent of assets, leading to a combined revenue of 8.6 percent of assets from all income sources. Lending activity, thus contributed about 57 percent of total income, on average, for private banks. With low operational costs around of 4.7 percent of assets and negligible provision costs (0.2 percent of assets), profits after taxess amounted to 2.8 percent of average assets.

As leverage (assets to total capital) was around 7.4x, this implied returns on average equity of 20.2 percent (i.e. 2.8 times 7.4), and an industry average earnings per share—given total capital was 1.5x shareholder capital—of 31 percent (i.e., 20.2 times 1.5).

Reflecting the above factors, returns to bank shareholders have remained high in recent years, though they are down by roughly one-fifth from their peak levels registered in 2010. Taken collectively, private banks as a whole have seen the average earnings per share fall from a peak of 39 percent in 2010 to 36 percent in 2013 to 31 percent in 2018. The highest EPS performance dropped from 61 to 43 percent over this period. Reflecting competitive dynamics within the industry, the six older private banks have seen falling EPS ratios (from 46 to 35 percent between 2010 and 2018), while the newer 10 banks have collectively seen a rise in EPS ratios from 23 to 28 percent during the same period.

Table 7.3: Dupont Analysis for Private Banking Sector

Dupont Decomposition	2013	2014	2015	2016	2017	2018
Interest income to Assets	5.8%	6.2%	6.7%	7.3%	7.1%	8.4%
Interest cost to Assets	-2.3%	-2.3%	-2.5%	-4.9%	-2.9%	-3.5%
Net interest income to Assets	3.5%	3.9%	4.1%	3.2%	4.3%	4.9%
Other income to Assets	4.8%	4.9%	4.7%	4.4%	4.3%	3.7%
Total income to Assets	8.3%	8.8%	8.8%	7.5%	8.6%	8.6%
Cost of risk to Assets	-0.5%	-0.3%	-0.2%	-0.4%	-0.3%	-0.2%
Operational costs to Assets	-3.5%	-4.3%	-4.5%	-4.5%	-4.9%	-4.7%
Taxes to Assets	-1.1%	-0.9%	-1.0%	-0.9%	-0.8%	-0.9%
Profits-After-Tax to Assets (ROA)	3.2%	3.3%	3.1%	1.7%	2.6%	2.8%
Assets to Capital (Leverage)	6.8	6.4	6.5	6.8	7.2	7.4
Profits to Equity (ROE)	21.6%	20.5%	19.7%	11.8%	17.8%	20.2%
Total Equity to Paid-up Equity	1.7	1.5	1.6	2.5	1.6	1.5
Earnings Per Birr 1,000 Share	36.0%	31.2%	30.8%	29.5%	28.4%	30.6%

Source: Banks annual reports

Qualitatively, growth in banking has been driven by some degree of product and service innovation. For example, the scope of deposit and lending services has broadened with new offerings such as tailored accounts (premium accounts, youth/women accounts, interest-free products) and specialized loan offerings (interest-free products, diaspora loans, and limited consumer loans). Digital initiatives and offerings in recent years have included a wide expansion in ATM services (now offered by all banks and—importantly—electronically interconnected among the different banks), POS devices at merchants, and different forms of mobile banking and/or mobile wallet services.

Outlook

Looking ahead, the outlook for the banking sector will be dependent, in the first instance, on trends for the two key financial resources that drive their growth (deposits and fx) and, to a secondary degree, by trends in bank-specific operating ratios such as interest margins, fees, costs, and capital base. More specifically:

- **Macro outlook (deposit and fx resources):** Deposit growth has averaged 28 percent over the past ten years and never fallen below 19 percent in even the slowest year. Deposit growth rates in the low 20s percent range is very likely for many more years to come, mainly in line with nominal GDP growth projections and even if deposit-to-GDP ratios were just to stay flat at current levels. For foreign exchange resources, the balance of payments outlook is much more positive for this year and next and aggregate fx inflows are expected to rise by 20-25 percent each year per our projections (see Chapter 10), which should translate to rising fee-based income for banks with large fx-related businesses.
- **Micro outlook (bank-specific operating ratios):** With respect to *net interest margins*, we expect a modest decline in the next year or two, as banks have become unexpectedly liquid in the past two quarters (July-December 2018) and will be keen to deploy their idle funds for some income generation. Given the mandatory minimum interest rate of 7 percent for savings deposits, a reduction in lending rates will necessarily reduce net interest margins, though banks can also stop accepting high-cost time deposits and we thus only expect a modest decline from current rates of about 7 percent to 5.0-5.5 percent. For *non-interest revenue*, namely fees on fx intermediation and on various bank guarantees, we don't see any pressures for a reduction in an environment of foreign exchange constraints (see Chapter 9), and banks are thus likely to be able to maintain current fees in the current policy environment (a Birr float would sharply reduce these fees as excess demand for foreign exchange is eliminated). Finally, on *cost-to-income* ratios, this is likely to rise materially (from unusually low bases at most banks) given emerging expense lines at most banks related to IT modernization, headquarter building projects, and rising rents and salaries in the sector; however, with strong growth in income, banks can bear higher incremental costs without much deterioration in cost-to-income ratios so we would not expect an increase of more than a few percentage points.
- **Leverage:** The ability to multiply returns from a relatively small capital base will be more limited as capital raising requirements will imply large percentage increases in capital in the coming years. Thus, while private banks' leverage (assets to total capital) has been rising in recent years (from 5.7x two years ago to 7.4x as of June 2018, on a weighted-average basis), which helped boost shareholder returns, we expect leverage ratios will stay broadly flat from here on, providing less support to projected EPS figures.

Putting all of the above assumptions into a simple model for the Ethiopian banking system we project a somewhat reduced (but still-high) earnings per share for the industry as a whole. On the plus side, the sector will benefit from still strong growth in resource mobilization (deposits and foreign exchange), but this is offset by forecast trends in key operational ratios that will work to reduce shareholder returns (net interest margin, cost-to-income ratios, and lower leverage). Of course, as in the past, the distribution of performance around the average can be quite varied, with the best performers—based on 2017-18 results—typically showing 2x the industry average EPS and the lowest performers showing 0.6x the industry average. Active competition in the areas of deposit mobilization, fx generation, and operating efficiency will thus remain—as before—a key source of differences in shareholder returns across banks.

TABLE 7.4: Banking Aggregates and Model Projections						
	<i>Actuals</i>			<i>Projections</i>		
	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
Private Banks						
<i>Key Financials: Birr bns</i>						
Deposits	146.5	201.8	278.5	342.6	424.8	531.0
Loans	91.4	132.6	178.8	216.3	272.6	348.9
NBE Bills	41.7	53.6	71.3	86.2	108.6	139.1
Total Assets	190.5	259.7	348.6	428.8	531.7	664.6
Total Capital	33.1	26.0	44.0	53.3	66.7	83.4
Profit Before Tax	5.8	7.6	10.4	10.6	12.8	13.7
Profit After Tax	4.5	5.7	8.1	8.2	9.8	10.6
<i>Key Operating Metrics</i>						
Deposit growth	19.3%	29.8%	28.4%	23.0%	24.0%	25.0%
Loan growth	24.1%	45.3%	34.1%	21.0%	26.0%	28.0%
Effective deposit rate	5.5%	3.9%	4.5%	4.6%	4.5%	4.5%
Effective lending rate	10.5%	10.4%	11.9%	13.5%	13.0%	12.0%
Net interest margin	4.6%	6.2%	6.9%	5.9%	5.7%	5.1%
Other income growth	13.2%	30.6%	10.9%	25.0%	22.0%	18.0%
Provision-to-Assets	-0.4%	-0.3%	-0.2%	-0.2%	-0.2%	-0.2%
Leverage	5.7x	10.0x	7.9x	8.0x	8.0x	8.0x
Commercial Bank of Ethiopia						
Deposits	288.6	364.9	451.8	555.7	689.1	861.4
Total Capital	16.1	42.6	43.9	48.2	53.1	58.4
Total Assets	384.6	485.7	565.5	695.6	862.5	1078.1
Profit before tax	13.7	14.6	10.3	12.9	15.5	18.6
All Commercial Banks						
Deposits	435.1	566.7	730.3	898.3	1,113.9	1,392.4
Total Capital	49.2	68.6	87.8	101.6	119.7	141.7
Profit before tax, Birr bns	19.5	22.2	20.7	23.5	28.2	32.3
Profit before tax, USD mns	\$ 922	\$ 988	\$ 789	\$ 837	\$ 953	\$ 1,039

Source: Bank reports and Cepheus Research projections

Finally, from a qualitative and service offerings perspective, Ethiopian banks should increasingly be expected to move into previously untapped or under-exploited areas. Such growth opportunities would include a move into untapped funding sources (bank bond issues, foreign borrowing), untapped lending spaces (consumer lending, credit cards, SME loans), digital products and payments, and capital markets related service offerings when reforms in this area eventually bring bond and equity markets. These emerging spaces represent a large expansion in the universe of Ethiopia’s financing sources, instruments, and users. Entry into these areas is thus an attractive proposition for banks in its own right, but also critical for the sector to serve as a well-functioning ‘circulatory system’ needed in a private-sector driven economy.

8. Is the financial sector opening soon?

Key points

- **We don't anticipate the financial sector opening up to foreign banks soon, and certainly not before 2020. This is not as big a handicap as it is often made out to be, in our view, since foreign bank entry is not a magic bullet that would do away with fx and credit constraints in the banking system.**
- **While there may not be an opening to foreign banks, there will clearly be an opening of the financial sector in other ways, as the Government's publicly announced policy commitments explicitly include the launch of capital markets by 2020.**
- **The launch of debt and equity markets will most likely focus—at least in the beginning—on domestic rather than foreign investors, but this could soon be broadened to include the latter for certain limited sub-categories of financial and related services.**

Ethiopia is one of the few economies in the world where the financial sector is closed to foreign investors. The restriction to foreign banks is—in some respects—not surprising as the financial sector has been designed to be state-led in line with the adopted development model, was only opened to the domestic private sector around two decades ago, and has until recently involved very traditional and regulated forms of banking that may not have attracted much foreign interest in the first place. In addition, policymakers have, in the past, routinely attributed restrictions of foreign investors to concerns about the regulatory capacity to exercise oversight over foreign-owned banks.

Being closed off from the rest of the world has no doubt slowed the degree of innovation in the financial sector, but it is also worth noting that the adopted economic development model has been as important in limiting the range of product and service offerings. For example, the scarcity of foreign exchange is often (mistakenly) attributed to the lack of foreign banks, but there really is no necessary connection: fx supplies are determined by balance of payments developments and broader financial sector policies, and the capital injection that a few foreign banks might bring is in no way of a material size compared to the size of the broader macroeconomy (minimum capital requirements are Birr 2bn or \$71mn, equivalent to a few days worth of imports). Similarly, the under-development of certain services such as credit cards, digital finance, consumer loans, and the like is seen to reflect the absence of foreign banks, but regulations and macro conditions are actually more important factors (i.e. credit cards are not yet permitted, regulations for digital finance remain somewhat restrictive, and banks have few long-term liabilities so cannot offer much in the way of long-term consumer credit). Still, with gradual regulatory reform and an increasingly competitive private banking environment, service offerings increasingly becoming modernized in line with international standards. Among other things, the past few years have brought a broader range of deposits accounts, loan offerings, interest-free

banking options and widespread use of alternative and electronic banking channels such as ATMs, Point of Sales (POS) devices, internet banking, and mobile banking.

While generally closed, small pockets of the financial sector are—it should be noted—already open to foreign investors. This includes capital leasing and fin-tech platforms that work in collaboration with banks and micro-finance institutions. At least two institutions are engaged in the latter, through the provision of mobile wallet and related services, while the capital leasing space has yet to attract a foreign investor.

Outlook

While an opening of the financial sector to foreign banks is not imminent, in our view, recent policy announcements point to financial sector opening in other ways. Most notably, per the Prime Minister's Office's recent "New Horizon of Hope" strategy summary, capital markets are to be in place by 2020. Based on other recent policy plans (see Government's Letter of Development Policy in recent World Bank loan package), this would be starting with the launch of market-based government securities and (we presume) followed by the eventual establishment of private bond and equity markets. These openings would represent a new chapter in Ethiopia's financial sector history, perhaps as significant as the opening to private sector banks some two decades ago.

An opening up of capital markets would considerably expand the universe of financing sources, instruments, and users. Breaking down the two broad areas of anticipated reform, we would note the following:

- **Debt:** An early start on the debt side, as noted above, would include the issuance of government securities at market-based rates, in an amount equivalent to 10 percent of the government's annual domestic financing needs (per recent World Bank loan document). With deficits of near 3.0 percent of GDP, and assuming domestic borrowing covers half of government financing needs, the amounts of new marketable government debt securities will be modest at first but could rise substantially over time. Beyond the launch of such marketable securities by Government, an openness to similar debt instruments could soon bring the issuance of private company bonds to domestic investors and the issuance of long-term bonds by private banks to domestic investors. Broadening the scope of debt instruments even further to *foreign* debt sources, one might expect further openness towards private company borrowings from foreign lenders (this has started already, but larger users and amounts would be possible), as well as bank borrowing from abroad for (long-term) fx-denominated loans that could be on-lent to local (fx-generating) businesses for equally long-term durations.
- **Equity:** On the equity side, the major opening in this space would be the issuance of state enterprise shares to foreign and domestic investors, as part of the partial privatization of the four big state firms (airlines, telecom, power, logistics) and the full privatization of other

upcoming cases. As highlighted in Chapter 1, the scope of potential inflows in this area, even using some crude comparison to similar companies in other markets, suggests magnitudes in the range of \$9-13bn over several years. Privatization related equity raising could be expected to be supplemented by private company share issuance to domestic investors, i.e., a stock market. The practice of private share issuance is, of course, already in place for dozens of firms (most notably for Ethiopia's 16 private banks and 16 insurance companies), but the difference with an organized capital market would be the use of readily traded marketable securities whose prices move regularly in line with firm performance and market conditions/sentiment. Broadening the scope of equity reform further (and making a more speculative judgement) it is possible that some degree of individual—as opposed to institutional—foreign minority equity participation in private Ethiopian banks might also be entertained by policymakers, which would address long-standing diaspora demands and serve as an easy means of boosting foreign exchange supplies. With several flagship state enterprises soon to have minority foreign shareholders of as much as 49 percent, it is possible that a similar openness to minority (individual) foreign share-holdings at private banks may not encounter much regulatory resistance in the period ahead.

Given the considerations above, what orders of magnitude might be involved for Ethiopia's emerging debt and equity markets? Looking at the two main components:

- **On the debt side**, a market in government securities would amount to just under Birr 10bn in the first two years (\$350mn at current exchange rates), based on budget deficits of near 3 percent of GDP and half of total financing being met by domestic borrowing in both 2020 and 2021. For bond issues by domestic corporates, this could also reach almost Birr 10bn assuming, say, 20-30 private corporate issues over two years in average amounts of near Birr 300mn each (smaller amounts would not warrant bond issues but instead be covered by bank debt). Adding in potential bond issues by financial institutions could add a similar Birr 10bn under some plausible assumptions (say, 8 banks issuing bonds equivalent to around 30 percent of their capital base). Collectively, domestic debt securities could thus reach close to Birr 30bn within the space of a few years.
- **On the equity side**, putting aside the large privatizations, a reasonable estimation would be that around 20-30 large private corporates (a figure that amounts to just 5 percent of the number of Large Tax-payers, per ERCA classifications) and 32 financial institutions (counting all banks and insurance companies) might move towards listing on a domestic stock market in the initial three years. This would imply a stock market with over 50 members and a market valuation—based on some comparable price-to-earning and price-to-book value ratios—of as much as Birr 270bn or \$9bn at current exchange rates (see Table 8.1). Relative to the economy's size, this would place the stock market size at around 6 percent of 2021-22 GDP for Ethiopia—a small share that points to the still limited size of Ethiopia's private sector compared to countries with long head-starts in this area such as Egypt (15% of GDP stock market capitalization at end-2018),

Bangladesh (16%), Tanzania (18%), Pakistan (19%), Ghana (21%), Kenya (26%), Indonesia (42%), Vietnam (76%), and South Africa (over 300%). However, adding in the large state-owned privatizations and assuming their equity shares would be listed on any future stock market could more than double this figure, potentially taking stock market capitalization to the range of 15-20 percent of GDP within the course of a few years.

TABLE 8.1: What Might An Ethiopian Capital Market Look Like in Three Years Time?

DEBT CAPITAL MARKETS, Estimated Birr Value in FY 2020-21		<i>Assumption</i>	Low est	High est	Mid-point
1 Market based government securities stock FY20, FY21			8.3	9.9	9.1
<input type="checkbox"/> Govt Deficits at 2.5% for FY20, FY21		2.5%			
<input type="checkbox"/> Govt Deficits at 3.0% for FY20, FY21		3.0%			
<input type="checkbox"/> Share of deficit financing from market securities		10.0%			
<input type="checkbox"/> Share of deficit financing from domestic sources		50.0%			
<input type="checkbox"/> Nominal GDP projection for FY20, FY21		3,303			
2 Private company bonds issued to domestic investors			4.0	12.0	8.0
<input type="checkbox"/> No of cos issuing bonds over three years, low-end		20			
<input type="checkbox"/> No of cos issuing bonds over three years, high-end		30			
<input type="checkbox"/> Average size of company bond issue, Birr bn, low-end		0.2			
<input type="checkbox"/> Average size of company bond issue, Birr bn, high-end		0.4			
3 Banks issuing bonds to domestic investors			6.8	13.5	10.1
<input type="checkbox"/> Banks issuing local bonds, FY 2019-2021		8			
<input type="checkbox"/> Average capital base in FY 2019-21, Birr bns		4.2			
<input type="checkbox"/> Bonds as percent of capital, low-end, Birr bns		20%			
<input type="checkbox"/> Bonds as percent of capital, high-end, Birr bns		40%			
EQUITY CAPITAL MARKETS, Estimated Birr Value in FY 2020-21			Low est	High est	Mid-point
1 Banks floating existing shares on local stock market			168.0	252.0	210.0
<input type="checkbox"/> No of Banks floating shares on stock market		16			
<input type="checkbox"/> Average capital base per bank in FY21, Birr bns		5.2			
<input type="checkbox"/> Average Price-to-Book ratio for banks, low estimate		2.0			
<input type="checkbox"/> Average Price-to-Book ratio for banks, high estimate		3.0			
2 Insurance cos floating existing shares on local stock market			15.8	26.4	21.1
<input type="checkbox"/> No of Insurance cos floating shares on stock market		16			
<input type="checkbox"/> Average capital base in FY 2019-21, Birr bns		0.7			
<input type="checkbox"/> Average Price-to-Book ratio for banks, low end		1.5			
<input type="checkbox"/> Average Price-to-Book ratio for banks, high-end		2.5			
3 Private cos issuing tradeable shares			8.0	18.0	13.0
<input type="checkbox"/> No of cos with share issues in three years, low-end		20.0			
<input type="checkbox"/> No of cos with share issues in three years, high-end		30.0			
<input type="checkbox"/> Average size of share issue, low-end		0.4			
<input type="checkbox"/> Average size of share issue, high-end		0.6			
TOTAL CAPITAL MARKETS			Low est	High est	Mid-point
Market capitalization, 2021 Est Value, Birr bns			210.8	331.7	271.3
<i>Of which</i> : Debt capital markets			19.0	35.4	27.2
<i>Of which</i> : Equity capital markets			191.8	296.3	244.1
Market capitalization, 2021-22 Est Value, % GDP			5.0%	7.8%	6.4%
<i>Of which</i> : Debt capital markets			0.4%	0.8%	0.6%
<i>Of which</i> : Equity capital markets			4.5%	7.0%	5.7%
Market capitalization, 2021 Est Value, USD bns			\$ 6.7	\$ 10.5	\$ 8.6
<i>Of which</i> : Debt capital markets			\$ 0.6	\$ 1.1	\$ 0.9
<i>Of which</i> : Equity capital markets			\$ 6.1	\$ 9.4	\$ 7.7

Source: Cepheus Research

9. When could foreign exchange availability start improving?

Key points

- **Foreign exchange availability has been among the major business challenges facing investors—domestic and foreign alike—over the past few years.**
- **FX availability for businesses could improve ‘with the stroke of a pen’ were the central bank to switch its policies to allow the Birr to float freely. Such a sudden switch in the fx policy regime is one of two possible approaches that could address foreign exchange shortages, and we think it could actually be done with little risk and limited adverse impacts (not to mention major positive spill-overs).**
- **As we see it, however, policy preferences remain tilted towards a second—more gradual—route for fx reform. Accordingly, while not ruling out policymakers’ ability to surprise, we take as our base case scenario an improvement in fx availability that occurs gradually over the next 1-3 years as multiple initiatives put in place to boost fx supplies—in exports, services, remittances, and FDI—begin to fully kick in.**

Foreign exchange availability has become one of the single most pressing challenges faced by many private businesses over the past few years. The challenging fx situation has reflected multiple factors, including poor export performance (due to a mix of weak commodity prices and the slow pick-up of emerging exports); large imports linked to mega-projects; and political unrest that affected remittances and grants in 2016 and 2017. As important, while the managed exchange rate policy of the central bank has adjusted the Birr in gradual increments, the magnitudes involved have fallen in short of moving the Birr to its market-clearing rate.

Reflecting the above factors, a review of Ethiopia’s fx sources over the past five years shows that there has been limited change in total gross inflows. Total gross fx inflows amounted to near \$21 billion last year—but this figure has only grown 44 percent over the past five years while Birr GDP has grown over 250 percent. Relative to the size of the economy measured in USD terms, total gross fx inflows have fallen from 31 to 25 percent of USD GDP over the past five years. Looking only at current account inflows (i.e. recurring items that generate inflows annually as opposed to ‘financing’ items such as FDI and borrowing from abroad), one sees that total inflows rose from only from \$11.1 to \$14.4bn, and have again fallen notably relative to the size of the economy—from 23 to 17 percent of USD GDP.

Table: 9.1: Ethiopia's FX Supply: sources, composition, and five-year trends

FX inflows, USD mns	2013	2014	2015	2016	2017	2018
Exports	3,116	3,300	3,019	2,868	2,907	2,840
Services	2,852	3,174	3,028	3,196	3,331	4,219
Remittances	2,489	2,968	3,796	4,420	4,428	5,121
Other private transfers	1,087	1,071	1,086	2,009	1,057	954
Official Grants	1,530	1,461	887	1,391	1,428	1,226
Loans	2,320	2,641	4,794	2,899	2,208	2,732
FDI	1,232	1,467	2,202	3,269	4,171	3,723
Private inflows			350	451	503	251
FX sources, total, USD mns	14,626	16,082	19,162	20,502	20,033	21,066
FX sources, total,% of GDP	31%	29%	30%	28%	25%	25%
FX sources, total, % total						
Exports	21%	21%	16%	14%	15%	13%
Services	19%	20%	16%	16%	17%	20%
Remittances	17%	18%	20%	22%	22%	24%
Official Grants	10%	9%	5%	7%	7%	6%
Loans	16%	16%	25%	14%	11%	13%
FDI	8%	9%	11%	16%	21%	18%
Private inflows	0%	0%	2%	2%	3%	1%
Other, E&Os	0%	0%	0%	0%	0%	0%

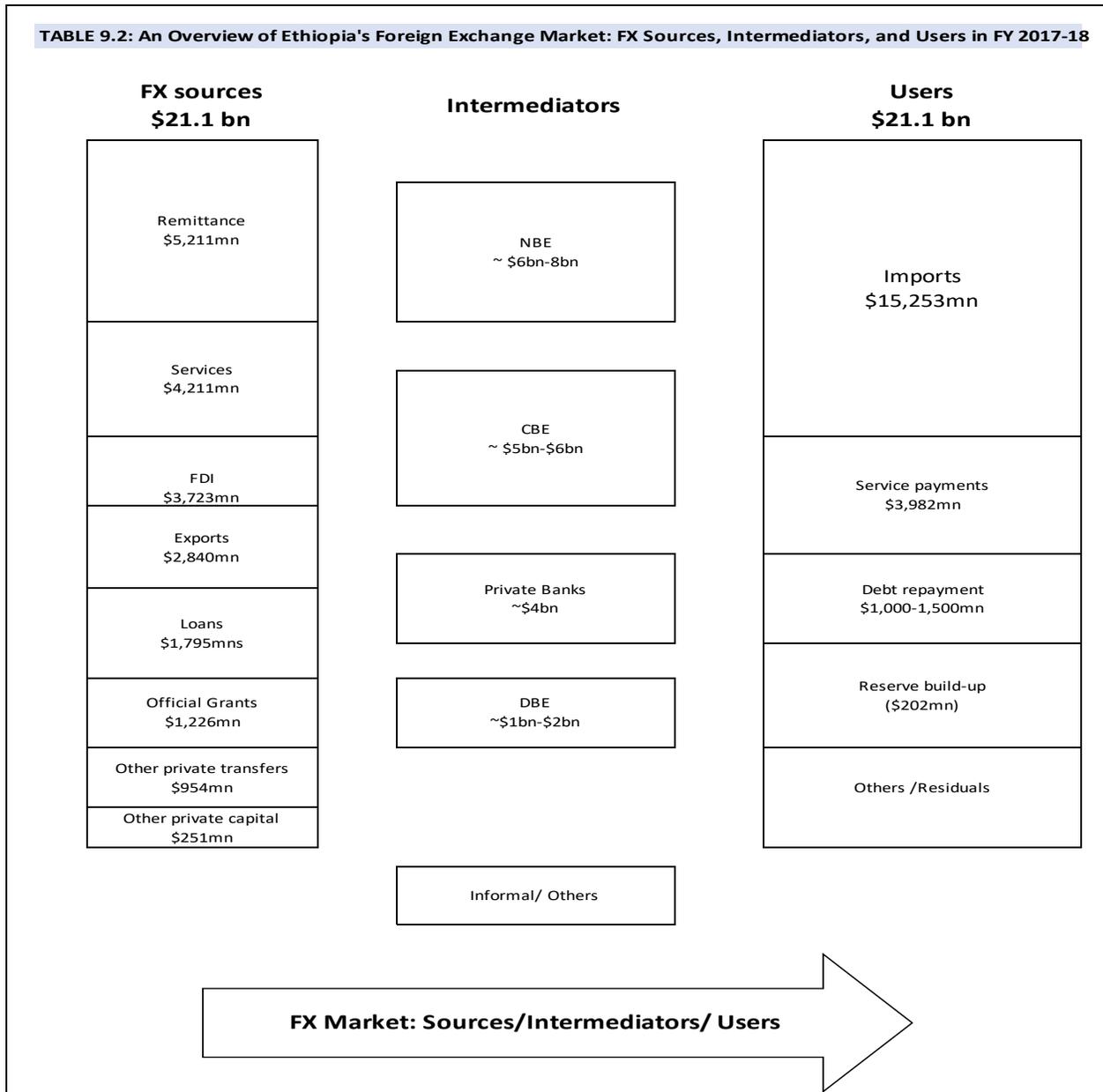
Source: NBE

With limited growth on the supply side, the user base of foreign exchange users—mostly importers—have had to be (de facto) rationed via queues for accessing fx funds at banks. Imports have averaged \$15 billion in recent years but this reflects only the addressable (rationed) import demand that is has been possible to accommodate given supply constraints. Such import compression—via unsatisfied demand at banks—has borne the burden of adjustment, and imports have fallen from 25 to 18 percent of GDP in recent years. A sharp import adjustment has thus been taking place in recent years (relative to GDP), but his has been driven more by rationing of demand (unmet queues at banks) rather than a price-based demand contraction.

The intermediation of foreign exchange funds—from sources to users—has involved five primary groups in Ethiopia, and each has had to address excess demand through selective and rationed allocations. The five main intermediators—or foreign exchange pools—are the National Bank of Ethiopia, the Commercial Bank of Ethiopia, the Development Bank of Ethiopia, private banks, and (though the amounts are not known) informal currency traders. Of the \$21 billion in fx inflows to the country, we estimate about \$6-8 billion flows through (i.e. is intermediated by) the National Bank, comprising foreign loans, grants, one-off deposits from foreign governments, and (since 2018) 30 percent of private banks customer fx inflows that are now surrendered to the central bank. CBE likely intermediated amounts of between \$5-6bn in recent years per their annual reports, reflecting the fx proceeds of its large (private) exporting clients, remittances channelled via its large branch network,

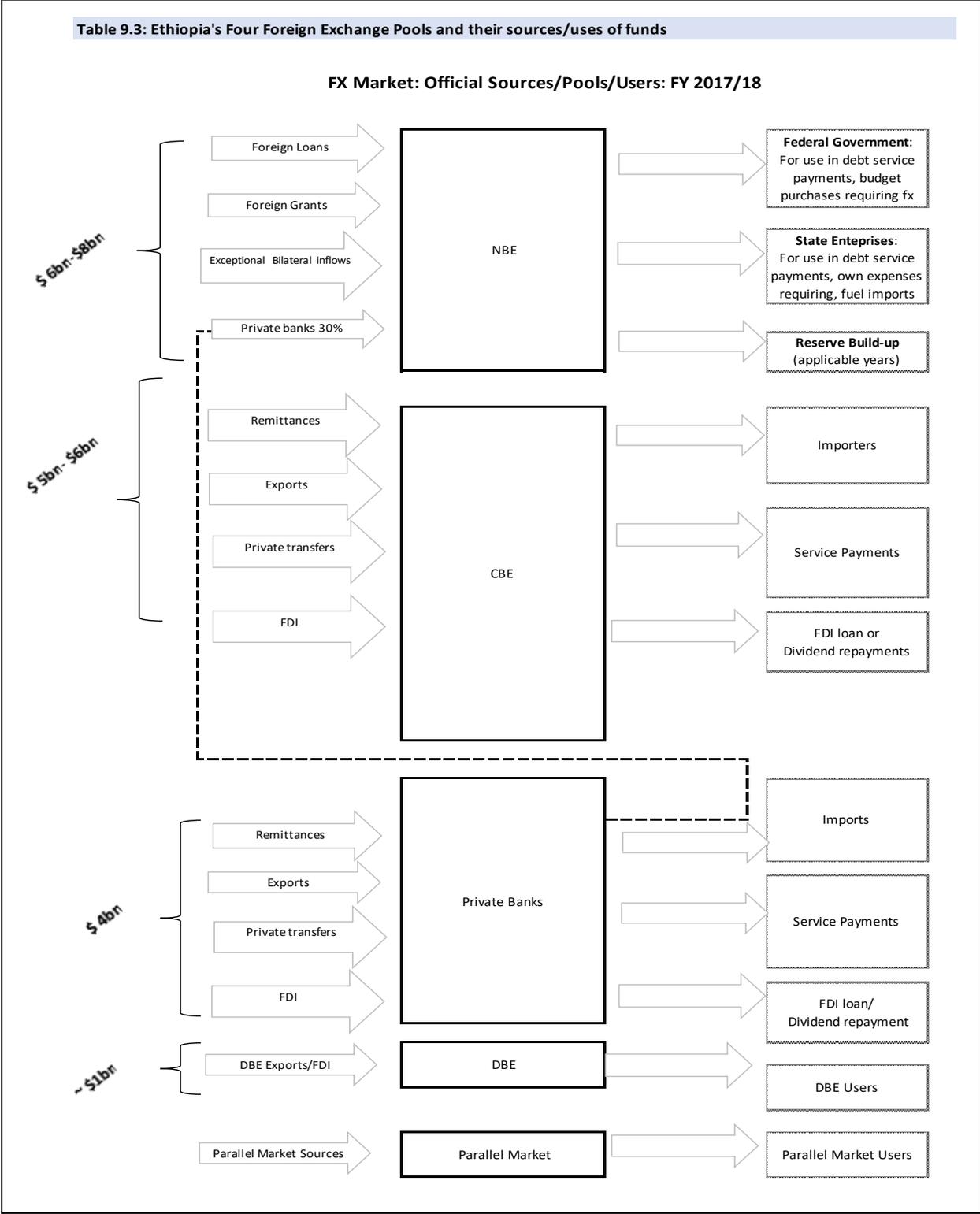
and inflows from its foreign/diaspora clients. Private banks gather fx from sources that are similar to the CBE (exporters, remittances, FDI inflows, foreign/diaspora accounts), and in FY 2017-18 collectively intermediated just under \$4 billion, by our compilation, with the largest ones (per their annual reports) intermediating around \$500-600 million per year, the median private bank intermediating around \$250-\$300 mn per year and the smaller ones intermediating amounts of around \$100mn a year. Finally, a black market also operates in parallel (for which figure are hard to arrive at) whose supply are cash notes from abroad plus fx inflows into accounts held abroad while the user base are importers/travellers.

TABLE 9.2: An Overview of Ethiopia's Foreign Exchange Market: FX Sources, Intermediators, and Users in FY 2017-18



Source: Cepheus classification based on NBE data

Table 9.3: Ethiopia's Four Foreign Exchange Pools and their sources/uses of funds



Outlook: To Float or not to Float

Looking ahead, when could fx availability start improving? In broad terms, there are two possible paths and, as is often the case with major macroeconomic reforms, one may envisage either a ‘big-bang’ or ‘gradualist’ approach.

If a ‘sudden switch’ or big-bang approach were followed, this would entail a quick and immediate exchange rate adjustment to a market-clearing rate followed by a floating mechanism so that it remains in line with market conditions. This route of reform makes fx immediately available to all, but of course at a *higher price*. Key questions and concerns with such a reform route are addressed in Text Box 9.4 and, in short, we think it could actually be done with little risk and limited adverse impacts, not to mention major positive spill-overs (TABLE 9.3).

The alternative to the above approach would involve awaiting current fx-boosting initiatives to gradually come on stream and thus removing—in due course—the fx availability problem. This would not be an unreasonable approach, but would involve a longer time frame and be dependent on the speed and performance of multiple underlying initiatives. Among the many initiatives in this area, the most notable prospects for fx improvement over the coming years include: (1) the coming on stream of manufactured exports from industrial parks; (2) a jump in electricity exports to neighbouring countries; (3) rising services exports as Ethiopian Airlines continues its rapid regional and global expansion; (4) rising tourism inflows given multiple initiatives in this area; (5) higher remittance inflows in light of recent reforms; (6) prospects for higher official grants following closer re-engagement with bilateral and multilateral partners; and (7) rising FDI in line with recent trends, privatization, PPPs, and reforms to the ease of doing business.

Given the two alternative paths above, which direction are policymakers likely to take? The selection of one approach over the other will reflect policy judgements about the relative risks and rewards. Though a bold move involving a ‘sudden switch’ would—in our view—be the preferred option, we think it is more realistic to anticipate policymakers pursuing the gradual adjustment scenario—likely to be viewed as a safer adjustment route while the alternative may be viewed as carrying higher risks and uncertain rewards. Accordingly, it is the gradual adjustment scenario that constitutes our base case scenario for 2019 and 2020 and that forms the basis for our macroeconomic projections.

TABLE 9.4: A Floating of the Birr: Might policymakers see this as a viable option in 2019?

Given far-reaching economic reforms put in place in 2018, it is reasonable to ask if a floating of the Birr might be seen as a viable reform option in 2019. In what follows, we address some of the factors that might drive policymakers in this direction, how implementation may unfold, and the likely risks and rewards involved. As highlighted above, however, we do not yet see this as the base case scenario for the purpose of our economic projections.

Motivations: Policymakers' motivation in opting for a floating rate would be to address one of the most serious bottlenecks confronting businesses—domestic and foreign alike—in the current economic environment. In particular, the reform would aim to remove distortions in the current fx system that:

- (1) hold back growth for many manufacturing firms (as they face difficulties in securing key imported inputs, operate at low capacity, and are often unable to plan long-term);
- (2) deprive many non-priority sectors, including virtually all service providers, from getting fx allocations at banks (as their turn in the queue rarely comes up and they're forced to resort to black market suppliers);
- (3) weaken export performance (as many exporters enter the business solely to supply parallel import activities, thus distorting export prices and competitive conditions for genuine exporters);
- (4) encourage excessive consumption (especially in consumer goods with domestic substitutes).
- (5) worsen capital flight and mis-invoicing (as businesses assume shortages will persist and use all available opportunities to keep fx earnings out of the country)

Perhaps most importantly, for a country that has set the establishment of an export-led manufacturing base as a core economic objective, policymakers will be keen to put in place a competitive exchange rate that fully promotes the country's industrialization aspirations and addresses manufacturers' key priorities—which would be for quick and assured access to fx at a somewhat higher cost rather than a lower price for buying fx but one with prolonged and unpredictable waiting times.

Implementation: If enacted, we would expect that any move to a Birr float would (as in many other such reforms in other countries) be preceded by and accompanied with a comprehensive set of preparations and measures that involve—among other things—an adequately stocked reserve pool (to counteract excessive initial swings that might be seen in the rate) and coordinated fiscal and monetary policies to ensure that inflation is kept under control right after the rate move.

Exchange rate impacts: Contrary to some commonly held views, there need not be a major crash in the exchange rate were a Birr float to be put in place. Some degree of depreciation is, of course, to be expected (as the current rate is not market-clearing), and the prevailing black-market rate provides an indication of where the new rate might settle. However, under a floating system, there will be forces that work to immediately boost fx supply and also just as quickly to restrain fx demand. Among the latter, somewhat higher rates will restrain import demand, especially of consumer goods and those with domestic substitutes. On the supply side, with a powerful signal that the currency issue is being solved once and for all, fx inflows should increase sharply following the rate adjustment as black market flows are channelled to official channels, particularly cash-based and remittance-related flows. Indeed, as confidence in future fx availability is fundamentally changed, and as fx inflows into bank channels rise over the near-term, the rate could actually strengthen (appreciate) from its initial level, as has been sometimes observed in the black market itself. Some degree of central bank intervention (via fx sales to banks or tighter monetary policy) also remains an option to moderate any unusual, temporary, or destabilizing movements that might arise following a float. Finally, fears of the black-market rate widening yet again from the new market-based rate would be unfounded as fx demand is fully met at bank counters and (except for a small amount of illicit activities) there would be little incentive or benefit from using black markets with very similar rates.

Inflation impacts: A Birr float can be expected to *temporarily* worsen inflation, but this impact should not be exaggerated (imports are roughly 18 percent GDP and probably a similar share of the consumer price index while many urban goods already reflect black market rates), can be mitigated (by subsidizing certain segments of imports/consumers that would be heavily affected), and would in any case be quite welcome and desirable for certain product categories (to discourage excessive consumption of imported consumer goods). Various tools at government's disposal—such as temporary subsidies or reductions to tariffs and excises—are also available should policymakers choose to leave unchanged certain sensitive prices and consumer segments. As is the case for many countries under-going such abrupt adjustment, a package of strong support from multilateral or bilateral sources (or alternatively early execution of plans for privatization or telecom license sales) could in parallel provide temporary foreign exchange and budgetary funds to assist with the transition to a new fx regime. As the size of current unmet fx demand can be reasonably estimated (based on average queuing times and backlog levels seen across all banks), the scale of needed funds to temporarily support the float can be approximately identified and sought to be met from sources such as privatization proceeds, telecom license sales, external support, or other such sources.

Would the risks be worth the rewards? The main risks of a Birr float lie with potentially destabilizing movements in inflation and/or the exchange rate, and the attendant impacts on real incomes and popular sentiment. But as emphasized above, a mix of coordinated policy planning, plus mitigating measures, plus protection to selected sensitive areas/consumers can substantially reduce such risks. Such targeted support

is already widely practiced with government policies on certain prices (fuel, electricity, import tariffs, telecom prices, excise rates) and certain subsidies (staple foods, housing, transport, safety nets, and others). Set against these (manageable) risks are a set of potentially profound and transformative benefits, including: elimination of fx queues at banks for private firms, government agencies, and consumers; revitalized manufacturing activity due to greater access to inputs/raw materials; fx access to long-deprived sectors (such as services) which were excluded from priority fx allocations despite their large GDP/employment/tax contributions; reduced corruption in fx allocations; operational predictability for industries to plan long-term based on realistic prices; and support for the export sector as firms now focus squarely on genuine export operations. Sharp reductions in many business costs can also be expected, including importer margins and bank fx fees, both of which are now highly inflated due simply to the current environment of fx constraints. Most importantly, as the true price of foreign currency feeds through to the economy, imported items deemed too expensive at the new exchange rate would face shrinking demand as they are then—by definition—beyond the capacity of the individual consumers/firms/public agencies involved. Regarding impacts on the budget, fx reform is probably neutral or positive as fx-denominated budgetary inflows (grants and loans are collectively above \$4bn annually) are higher than public sector debt service dues (\$1.5bn last year), so the Birr equivalent of the former will exceed the Birr equivalent of the latter. With respect to exports, improved Birr returns should boost their performance over time, but even if this takes time due to slow supply responses in Ethiopia, the balance of payments can still improve quickly and sharply, as excessive imports are compressed within a very short period of time. Finally, an open and predictable fx regime removes one major disincentive that was important for *some* foreign investors, and should substantially boost new inflows from this sub-group of investors that had been on the side-lines due to policies in this area. All things considered, with adequate preparation, careful implementation and due attention to sensitive products/segments that might need (temporary) protection, the risks from a Birr float are limited in our view while the rewards substantial for day-to-day business operations, for future investment flows, and for more durable, long-term economic growth.

10. Where is the Birr heading?

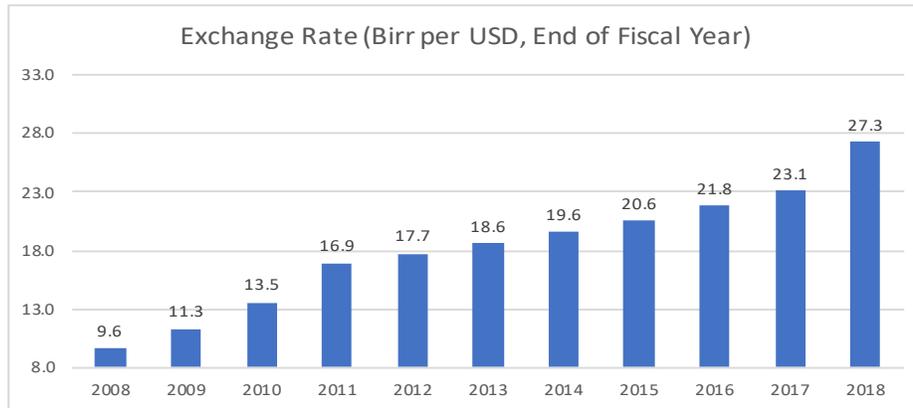
Key points

- **Absent a switch in the FX regime, we expect the central bank to adjust the Birr by taking into account inflation trends, movements in the USD, and balance of payments conditions.**
- **For 2018-19, we expect inflation to be roughly double that in partner countries, USD rates to appreciate slightly vs the Euro (per most market forecasts), and a positive balance of payments outturn (we forecast a strong increase in fx reserves this year following last year's modest decline).**
- **In light of the above, we expect the central bank to target a depreciation rate that is in line with inflation differentials vs trading partners plus USD appreciation vs major currencies—a combined sum of around 7 to 8 percent. We thus forecast a buying rate (at which banks buy dollars from customers) of 29.1 Birr/USD at end-June 2019 and 30.1 Birr/USD at end-2019. The selling rates (at which importers buy dollars from banks) should be exactly 2 percent higher, per the long-standing fixed spread between these two rates.**

Movements in the Birr rate are currently set by the National Bank of Ethiopia on a daily basis and subsequently communicated to commercial banks each morning for that day's applicable rate. The central bank does not, on its own, have a formal communication system to explicitly relay its rules or targets for the exchange rate. The closest guidance available on exchange rate direction comes (occasionally) from annual budget speeches, where in recent years a planned rate of depreciation has been announced. For example, in June 2016, the budget speech announced a planned depreciation rate of 6 percent for the then upcoming FY 2016-17 fiscal year (the actual outturn was 6.2 percent). In mid-2017, the President's annual budget speech indicated that an exchange rate adjustment will 'be studied and implemented' which, a few weeks later, was followed by a devaluation of 15 percent.

Exchange rate movements in recent years have followed a 5-7 percent annual depreciation rule, alongside periodic one-off devaluations. Since 2010, annual Birr depreciation has averaged between 5-7 percent per year, except in years which saw one-off devaluations such as in July 2009 (8 percent), September 2010 (19 percent) and most recently in October 2017 (15 percent). The years of devaluations typically took place in years when inflation was much higher than trading partners, resulting in a loss of competitiveness (real appreciation) and thus a need to make a level adjustment in the rate.

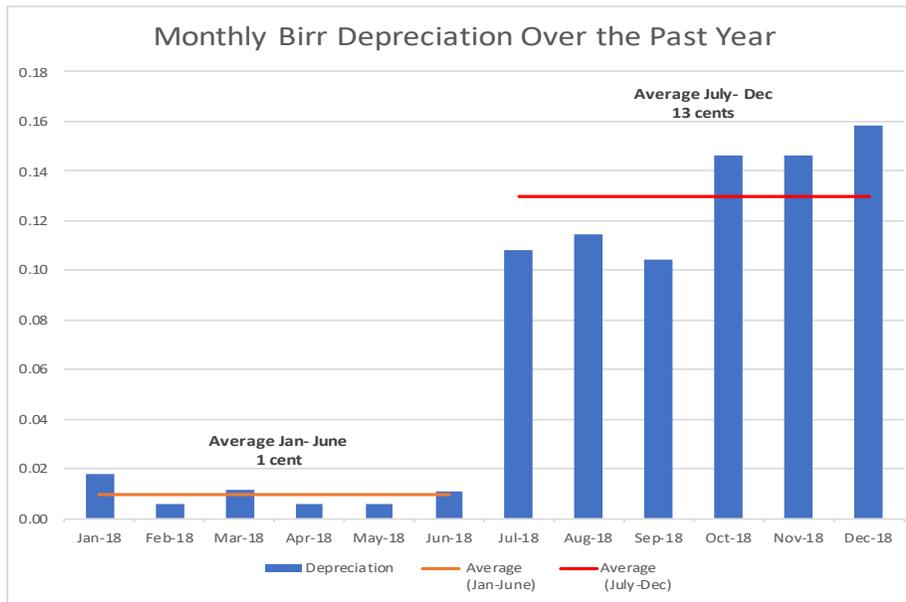
Table 10.1: Exchange Rate Movements, A Ten-Year Perspective



Source: FX data on CBE website

Following the 15% Birr devaluation in October 2017, the exchange rate was initially kept relatively unchanged for the first half of 2018, but has since depreciated at a noticeably faster pace. While the initial months following the devaluation suggested a relatively flat exchange rate would remain in place (the depreciation averaged only one cent per month from January to June 2018), rate adjustments in the Birr have subsequently averaged 13 cents per month since July 2018. This pace of rate adjustment corresponds to an annual depreciation rate of around 6 percent. The faster pace of Birr depreciation appears to be in response to still-high inflation, which remained in the low teens in the year following the deprecation and thus eroded most of the competitiveness gains from the devaluation. Indeed, with the consumer price index up 12 percent between October 2017 and October 2018, the real effective exchange rate has almost fully returned to its (elevated) level that prevailed before the devaluation.

TABLE 10.2: Monthly Depreciations over the Past Year, in Birr cents per month



Source: FX data on CBE website

Outlook

Assuming the continuation of the ‘gradual crawl’ fx regime, three key variables should figure prominently in the central bank’s exchange rate decision-making: (1) Inflation relative to Ethiopia’s trading partners; (2) USD movements against other major currencies (as the Birr is fixed relative to the USD and it thus appreciates versus other currencies when the USD appreciates vs those currencies); and (3) balance of payments conditions.

Considering the range of possible outcomes for the three variables above, we assume the central bank’s decision-making process can be summarized by the typology presented in Table 3. In particular, if Ethiopia is experiencing low inflation (vs trading partners) and the balance of payment is in surplus, the central bank would find no need to move the exchange rate or to engineer a depreciation. Conversely, if Ethiopia’s inflation is high (vs partners) and the balance of payments also in significant deficit, this merits a depreciation plus an added one-off devaluation—as was the case in FY 2017-18. By our judgement, other possible combinations (high inflation with a BOP surplus) would merit a gradual depreciation but not call for a one-off devaluation—which is our expectation for this year. In the latter case (high inflation with a BOP surplus), the size of the gradual depreciation would be guided by inflation differentials (vs trading partners), but also be adjusted for movements in the USD vs other major currencies (i.e., if the USD appreciates vs other major currencies, the magnitude of Birr depreciation needed to maintain competitiveness would seek to cover the inflation differential vs trading partners plus an extra amount for offsetting the USD appreciation).

Table 10.3: A Typology for the Exchange Rate's Determination and Presumed Policy Rules

	High Inflation	Low Inflation
Rising FX Reserves	<p><i>Expected Policy:</i> Crawl depreciation in line with inflation differences</p> <p><i>Applicable Year:</i> FY 2018-19</p>	<p><i>Expected Policy:</i> No depreciation and no devaluation</p> <p><i>Applicable Year:</i> No recent experience</p>
Falling FX Reserves	<p><i>Expected Policy:</i> Crawl depreciation plus one-off devaluation</p> <p><i>Applicable Year:</i> FY 2017-18</p>	<p><i>Expected Policy:</i> Crawl depreciation, uncertain magnitude</p> <p><i>Applicable Year:</i> No recent experience</p>

Source: Cepheus Research Classification

For FY 2018-19, we expect Ethiopia's inflation to be above trading partners, some degree of USD appreciation vs other currencies, and a surplus on the balance of payments. More specifically:

- **Inflation vs trading partners:** Our projection for FY 2018-19 year-average inflation is around 9 to 10 percent, while inflation in Ethiopia's export markets (taking the IMF's projected inflation for the top 20 destinations) is projected to be around 4.5 percent. Accordingly, a depreciation similar to these inflation differences would be required—all else equal—to keep the real effective exchange rate broadly unchanged.
- **USD dollar:** With respect to the USD, to which the Birr is linked, an appreciation of USD to other currencies is expected by most market analysts. Taking an average of market forecasts, we work with a 3 percent USD appreciation vs major currencies as the base case projection for 2019.
- **Balance of payments:** With respect to the balance of payments, we expect reserves to rise in FY 2018-19 following the reserve decline (from \$3,197mn to \$2,996mn) seen in FY 2017-18. Growth in goods exports will remain weak this year, given observed first quarter export outturns (7 percent year-on-year decline), the still early stages of industrial park exports (textiles, leather, shoes) and what is likely to be a slow-growth year for both coffee and oilseeds (both were down versus year ago levels for the July-September 2018 quarter). Services exports will likely rise by near 10 percent, given the strength of Ethiopian Airlines and its on-going passenger and cargo

volume expansions this year. A big improvement is forecast for remittances (expected to reach \$5.6bn), given diaspora responses to recent reforms and the re-launching of worker placement programs to the Middle East, while grants should begin to improve sharply over last year's levels with rising external bilateral support for the new administration. Within the capital account, we project FDI will reach \$4bn for the year (not yet assuming any privatization inflows for FY 2018-19), while public sector borrowing should be in the neighbourhood of \$2.3 billion in concessional loans. The net impact of the above developments will be a balance of payments surplus of around \$900 million, and a corresponding rise in reserves from \$3.0bn in June 2018 to just under \$4.0bn by June 2019.

Table 10.4: Ethiopia's Balance of Payments: Recent Outturns and Projections

Balance of Payments: Selected Items	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20
Exports of goods (USD mn)	3,300	3,019	2,868	2,908	2,840	2,953	3,367
Exports of services (USD mns)	3,174	3,028	3,196	3,331	4,220	4,557	5,013
Imports of goods (USD mn)	(13,712)	(16,458)	(16,725)	(15,803)	(15,253)	(16,016)	(17,938)
Imports of services (USD mns)	(2,461)	(3,107)	(3,442)	(3,393)	(3,983)	(4,529)	(4,982)
Remittances (USD mn)	2,968	3,797	4,420	4,428	5,121	5,582	6,029
Private transfers (USD mn)	1,071	1,085	2,008	1,058	953	1,039	1,122
Foreign official grants (USD mn)	1,461	1,508	1,391	1,428	1,226	1,526	1,826
Current account balance (USD mn)	(4,352)	(7,401)	(6,657)	(6,528)	(5,253)	(5,364)	(6,165)
Current account balance (% GDP)	-7.8%	-11.5%	-9.0%	-8.0%	-6.3%	-5.7%	-5.9%
Foreign direct investment (USD mn)	1,467	2,202	3,269	4,171	3,723	4,000	6,500
Public sector borrowing (USD mn)	2,309	3,352	1,628	1,402	1,632	1,600	1,775
Overall External Balance (USD mn)	(97)	(521)	(831)	659	(201)	986	2,510
Stock of Foreign Reserves, (USD mn)	2,496	3,249	3,402	3,197	2,996	3,982	6,492
Stock of Foreign Reserves, months imports	2.2	2.4	2.4	2.4	2.4	3.0	4.3
External Debt Stock (Public Sector, USD bn)	14.0	19.1	21.5	23.4	25.9	28.0	30.3
External Debt Stock (Public Sector, % GDP)	25.2%	29.6%	29.0%	28.7%	30.9%	29.5%	28.7%
Growth of Goods Exports	5.9%	-8.5%	-5.0%	1.4%	-2.3%	4.0%	14.0%
Growth of Goods Imports	19.6%	20.0%	1.6%	-5.5%	-3.5%	5.0%	12.0%
Market Ratings and Sovereign Bond Performance							
Country Ratings	...						
Standard and Poor's	...	B	B	B	B	...	...
Fitch	...	B	B	B	B	...	...
Moody's	...	B1	B1	B1	B1	...	...
Ethiopia Sovereign Bond: \$1bn issued Dec 2014							
Yield in percent (fiscal year average)	...	6.83%	7.96%	7.40%	6.34%	...	...

Source: NBE, MOFEC, CSA, and IMF for historical data series; Cepheus Capital Research for certain estimates and projection years.

Based on the above forecasts, and given our assumption of the NBE’s approach to exchange rate determination, we expect the central bank to implement a depreciation in FY 2018-19 that is in line with combined sum of Ethiopia’s inflation differentials (vs trading partners) and the projected USD appreciation (vs major currencies). We thus expect to see the central bank engineering a depreciation equal to the around 7.5 percent for this year. On this basis, we project the exchange rate will reach Birr 29.1 per USD by June 2019 and Birr 30.1 per USD by December 2019. With a slightly lower inflation differential next year, and a second projected year of rising reserves, we project a 5 percent annual depreciation FY 2019-20, and thus forecast a rate 30.9 Birr/USD by June 2020, and 31.8 Birr/USD by December 2020. The above apply to buying rates (at which exporters sell dollars to banks), and the corresponding selling rates (at which importers buy dollars from banks) should be exactly 2 percent higher, per the long-standing fixed spread between these two rates. As underlined in Chapter 9, all of the above forecasts assume it is the gradual fx adjustment scenario—rather than a switch to a free float of the Birr—that drives central bank policy efforts to improve foreign exchange conditions over the coming years.

Table 10.5: Exchange Rate Projections, to end-2019

	Buying Rate, Birr per USD	Selling Rate, Birr per USD	Depreciation rate from year-ago
<i>Actuals: End-Month</i>			
October 2018	27.74	28.29	2.6%
November 2018	27.88	28.44	2.6%
December 2018	28.04	28.60	3.1%
<i>Projections: End-Month</i>			
January 2019	28.22	28.78	3.6%
February 2019	28.39	28.96	4.3%
March 2019	28.57	29.14	4.9%
April 2019	28.74	29.32	5.5%
May 2019	28.92	29.49	6.1%
June 2019	29.09	29.67	6.7%
July 2019	29.27	29.85	6.9%
August 2019	29.44	30.03	7.1%
September 2019	29.62	30.21	7.4%
October 2019	29.79	30.39	7.4%
November 2019	29.97	30.57	7.5%
December 2019	30.14	30.75	7.5%

Source: CBE website for historical data, Cepheus Research for projections

APPENDIX: Ethiopia, Key Macroeconomic Indicators, 2010-20

	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20
	<i>Actual</i>	Actual	Actual	Actual	Actual	Actual	Actual	Actual	<i>Projection</i>	<i>Projection</i>
Real Sector: GDP, Prices, and Investment										
Real GDP growth	11.4%	8.7%	9.9%	10.3%	10.4%	8.0%	10.1%	7.7%	9.0%	8.5%
<i>Agriculture growth</i>	9.0%	4.9%	7.1%	5.4%	6.4%	2.3%	6.7%	3.5%	6.5%	5.0%
<i>Industry growth</i>	18.6%	19.7%	24.0%	17.1%	19.9%	20.5%	20.3%	12.2%	12.0%	15.0%
<i>Services growth</i>	17.0%	9.6%	9.0%	13.0%	11.1%	8.6%	7.2%	8.8%	8.8%	6.4%
Inflation: CPI (end-of-period)	38.1%	20.7%	7.4%	8.5%	10.4%	7.5%	8.8%	14.7%	9.5%	8.0%
Inflation: CPI (period average)	18.1%	34.1%	13.5%	8.1%	7.7%	9.7%	7.2%	13.1%	10.0%	8.0%
Nominal GDP growth	31.6%	45.1%	16.0%	22.4%	22.4%	20.8%	16.9%	20.2%	21.0%	17.2%
Nominal GDP level (Birr billions)	515.1	747.3	866.9	1,060.8	1,298.0	1,568.1	1,832.6	2,202.4	2,663.8	3,121.9
Nominal GDP level (USD billions)	\$ 32.0	\$ 43.2	\$ 47.6	\$ 55.5	\$ 64.5	\$ 74.1	\$ 81.6	\$ 84.0	\$ 94.9	\$ 105.4
Exchange rate (Birr/USD, year-average)	16.10	17.28	18.23	19.11	20.13	21.16	22.47	26.23	28.08	29.63
Exchange rate (Birr/USD, end-of-period)	16.82	17.73	18.64	19.58	20.57	21.80	23.11	27.26	28.90	30.35
Exchange rate annual depreciation	24.8%	7.3%	5.5%	4.8%	5.3%	5.1%	6.2%	16.7%	6.0%	5.0%
Investment-to-GDP ratio	27.2%	34.6%	32.6%	38.0%	39.3%	37.3%	38.4%	34.1%	34.5%	36.5%
Domestic Savings-to-GDP ratio	12.8%	16.5%	15.9%	20.5%	21.8%	22.4%	22.4%	24.3%	24.0%	23.0%
External Savings-to-GDP ratio	14.4%	18.1%	16.7%	17.5%	17.5%	14.9%	16.0%	9.8%	10.5%	13.5%
Banking Sector										
Deposits at all commercial banks (Br bn)	143.3	189.3	237.8	292.9	366.5	436.7	567.7	729.1	889.5	1,103.0
Loans by all commercial banks (Br bn)	61.9	85.4	116.5	145.6	189.3	232.1	289.8	355.4	419.4	511.6
NBE Bills held by all comm banks (Br bn)	3.0	11.0	19.1	25.1	37.4	49.9	54.6	70.1	80.1	93.8
Bonds held by all commercial banks (Br bn)	43.1	64.5	82.8	111.8	152.7	188.7	237.8	291.4	349.7	442.3
Total bank financing: Loans/Bills/Bonds, (Br bn)	108.0	160.9	218.4	282.5	379.4	470.7	582.2	716.9	849.1	1,047.7
Deposit-to-GDP ratio (%)	27.8%	25.3%	27.4%	27.6%	28.2%	27.8%	31.0%	33.1%	33.4%	35.3%
Total bank financing-to-Deposit ratio (%)	83.3%	95.8%	94.8%	99.8%	107.4%	109.3%	109.5%	105.3%	95.5%	95.0%
Total commercial bank financing-to-GDP ratio (%)	21.0%	21.5%	25.2%	26.6%	29.2%	30.0%	31.8%	32.6%	31.9%	33.6%
Annual growth in bank deposits (%)	40.0%	32.1%	25.6%	23.2%	25.1%	19.2%	30.0%	28.4%	22.0%	24.0%
Annual growth in total bank financing (%)	50.7%	49.0%	35.7%	29.4%	34.3%	24.1%	23.7%	23.1%	18.4%	23.4%

Source: NBE, MOFEC, CSA, and IMF for historical data series; Cepheus Capital Research for certain estimates and projection years.

APPENDIX: Ethiopia, Key Macroeconomic Indicators, 2010-20

	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20
	<i>Actual</i>	Actual	Actual	Actual	Actual	Actual	Actual	Actual	<i>Projection</i>	<i>Projection</i>
Fiscal Sector										
Revenue and grants (Birr bns)	85.6	115.7	137.2	158.1	199.6	243.7	269.1	292.2	254.8	285.4
Expenditure (Birr bns)	93.8	124.4	153.9	185.5	230.5	272.9	329.3	372.0	346.9	388.5
Fiscal balance after grants (Birr bns)	-8.2	-8.7	-16.7	-27.4	-30.9	-29.3	-60.2	-79.8	-92.1	-103.2
Revenue and grants (% GDP)	16.6%	15.5%	15.8%	14.9%	15.4%	15.5%	14.7%	13.3%	9.6%	9.1%
Expenditure (% GDP)	18.2%	16.6%	17.8%	17.5%	17.8%	17.4%	18.0%	16.9%	13.0%	12.4%
Fiscal balance after grants (% GDP)	-1.6%	-1.2%	-1.9%	-2.6%	-2.4%	-1.9%	-3.3%	-3.6%	-3.5%	-3.3%
Public Sector Debt (% GDP)	36.2%	30.6%	41.9%	45.7%	52.9%	52.4%	55.3%	57.9%	57.0%	57.2%
External Debt (% GDP)	24.4%	20.6%	23.6%	25.2%	29.6%	29.0%	28.7%	30.9%	29.5%	28.7%
Domestic Debt (% GDP)	11.9%	10.1%	18.3%	20.5%	23.3%	23.4%	26.5%	27.0%	27.5%	28.5%
External Sector: Balance of Payments										
Exports of goods (USD mn)	2,747	3,153	3,116	3,300	3,019	2,868	2,908	2,840	2,953	3,367
Exports of services (USD mns)	2,586	2,811	2,853	3,174	3,028	3,196	3,331	4,220	4,557	5,013
Imports of goods (USD mn)	(8,253)	(11,018)	(11,461)	(13,712)	(16,458)	(16,725)	(15,803)	(15,253)	(16,016)	(17,938)
Imports of services (USD mns)	(1,828)	(2,639)	(2,281)	(2,461)	(3,107)	(3,442)	(3,393)	(3,983)	(4,529)	(4,982)
Remittances (USD mn)	2,032	2,401	2,489	2,968	3,797	4,420	4,428	5,121	5,582	6,029
Private transfers (USD mn)	715	845	1,086	1,071	1,085	2,008	1,058	953	1,039	1,122
Foreign official grants (USD mn)	1,861	1,788	1,530	1,461	1,508	1,391	1,428	1,226	1,526	1,826
Current account balance (USD mn)	(210)	(2,755)	(2,781)	(4,352)	(7,401)	(6,657)	(6,528)	(5,253)	(5,364)	(6,165)
Current account balance (% GDP)	-0.7%	-6.4%	-5.8%	-7.8%	-11.5%	-9.0%	-8.0%	-6.3%	-5.7%	-5.9%
Foreign direct investment (USD mn)	1,243	1,072	1,232	1,467	2,202	3,269	4,171	3,723	4,000	6,500
Foreign borrowing (USD mn)	2,073	1,605	1,270	2,309	3,352	1,628	1,402	1,632	1,600	1,775
Overall External Balance (USD mn)	1,446	(1,067)	(7)	(97)	(521)	(831)	659	(201)	986	2,510
Stock of Foreign Reserves, (USD mn)	3,044	2,262	2,368	2,496	3,249	3,402	3,197	2,996	3,982	6,492
Stock of Foreign Reserves, months imports	4.4	2.5	2.5	2.2	2.4	2.4	2.4	2.4	3.0	4.3
External Debt Stock (Public Sector, USD bn)	7.8	8.9	11.2	14.0	19.1	21.5	23.4	25.9	28.0	30.3
External Debt Stock (Public Sector, % GDP)	24.4%	20.6%	23.6%	25.2%	29.6%	29.0%	28.7%	30.9%	29.5%	28.7%
Growth of Goods Exports	37.1%	14.8%	-1.2%	5.9%	-8.5%	-5.0%	1.4%	-2.3%	4.0%	14.0%
Growth of Goods Imports	-0.2%	33.5%	4.0%	19.6%	20.0%	1.6%	-5.5%	-3.5%	5.0%	12.0%
Market Ratings and Sovereign Bond Performance										
Country Ratings	...	...	...	...		
Standard and Poor's	...	...	...	...	B	B	B	B	...	...
Fitch	...	...	...	...	B	B	B	B	...	...
Moody's	...	...	...	...	B1	B1	B1	B1	...	...
Ethiopia Sovereign Bond: \$1bn issued Dec 2014										
Yield in percent (fiscal year average)	...	...	...	...	6.83%	7.96%	7.40%	6.34%	...	...

Source: NBE, MOFEC, CSA, and IMF for historical data series; Cepheus Capital Research for certain estimates and projection years.

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