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Economic Prospects for Ethiopia and Challenges for Poverty Reduction

Espen Villanger

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Contents

1. Introduction

The purpose of this report is twofold. First, in section 2, I will describe Ethiopia's economic performance as of today and the expected future development. This part focuses on expected economic growth and on the impact on the economy of the expected increase in inflation, the increase in oil prices, the removal of petroleum subsidies and the suspension of Direct Budget Support (DBS) by donors. Second, in section 3, I will discuss the challenges for the Ethiopian poverty reduction strategy and the aims therein. This part assesses the poverty analysis in the PASDEP and whether this is coherent with the strategies, to what degree the growth strategies are pro-poor, the prospects for poverty reduction and finally how PASDEP balances growth with distributional issues. Section 4 then points out some issues that could be followed up.

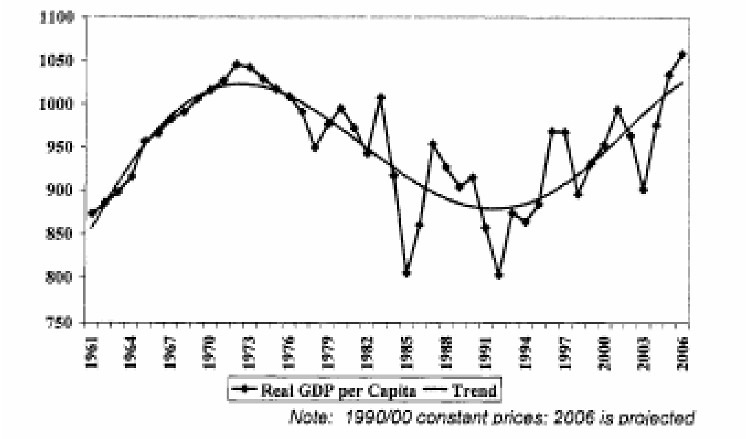
2. Economic performance and future prospects

The purpose of this section is to discuss Ethiopia's present economic performance and its expected economic development. This section contains, in line with the ToR, an overview of economic growth prospects and its rural/urban distribution (section 2.1), a discussion of possible consequences for the macroeconomic environment of increasing inflation (section 2.2), the impact of increased oil prices on the Government's budget (section 2.3), prospects for Ethiopian exports, and finally, a discussion of the macroeconomic impacts of the suspension of Direct Budget Support (section 2.5).

2.1 Economic growth prospects

The agricultural sector in Ethiopia contributed around 48 % to GDP in 2004/05 (IMF 2006a), employs 85 % of the population, and is largely rain fed (PASDEP 2006). Hence, the country's growth performance in a single year is highly dependent on the weather conditions for agriculture. Figure 1 below illustrates this point, and highlights the importance both of assessing the growth trends over several years and of decomposing the growth rate into different sectors in order to get a proper picture of the future prospects.

Figure 1. Real GDP per capita (Ethiopian Birr). Source: World Bank (2006a)



Despite being a very rough smoothing of the data points in figure 1, the recent trend seems to be a sharp increase in GDP in Ethiopia after the drought-induced recession. The average annual population growth was approximately 2.2 % between 1998 and 2004, and the increase in real GDP per capita from 2003/04 has substantially improved the wellbeing of many Ethiopians. The preliminary IMF figures show that *per capita* growth in GDP in 2003/04 was 9.1%, for the following year 6.7 %, and is expected to be 2.9 % for 2005/06. The perception that many Ethiopians have experienced improvements in economic wellbeing is supported by a disaggregation of the growth figures as shown in table 1 below, which indicates that all sectors have prospered.

Table 1. Selected macroeconomic indicators. Source: World Bank (2006a).

	1998/99	1999/00	2000/01	2001/02	2002/03 (prelim.)	2003/04 (prelim.)	2004/05 (prelim.)	2005/06 (proj.)
			(percent growth)					
GDP at factor cost	7.1	5.3	7.4	-0.3	-3.8	11.3	8.9	5.1
Agriculture	4.3	3.2	10.7	-2.3	-11.6	17.7	12.1	4.7
Industry	7.1	3.6	4.8	5.1	5.5	6.8	6.6	6.3
Services	11.5	8.9	3.8	0.5	3.3	5.8	5.8	5.4
Inflation (CPI)	4.8	6.2	-5.2	-7.2	15.1	8.6	6.8	10.8
Food CPI	9.0	8.6	-10.6	-12.7	24.8	11.8	7.7	
Non food CPI	-2.0	1.8	4.9	1.6	1.6	3.2	5.4	
External sector								
Exports (GNFS)	-11.9	7.6	-0.5	0.4	16.0	31.4	22.1	20.7
Imports (GNFS)	13.3	4.6	-1.2	7.1	13.2	35.1	37.7	20.9
			(period average)					
Exchange rate (Birr/US$)	7.51	8.15	8.33	8.54	8.58	8.62	8.65	

The *rural sector*, which consists almost entirely of agriculture, has experienced large volatilities. The drought in 2001/02-2002/03 caused a reduction in GDP from agriculture of almost 14 %. Despite a growth of 3–5 % in industry and services (generally located in the *urban sector)*, which contributed 57 % to GDP, the national GDP dropped by 4 % during those years.[1] In the aftermath of economic crises like drought we usually see a rebound in GDP that materialises in high economic growth rates. This may be nothing more than production picking up and returning to normal levels, which is what happened to a large extent in Ethiopia in 2003/04 with agricultural growth of 17 %. However, the subsequent growth in 2004/05 of 12 % is rather strong and lifted the incomes produced in the agricultural sector far above the pre-drought level.

The *urban sector*, industry and services, confirms that Ethiopia has had a very strong and broad growth performance during recent years. Industry and services have grown between 6 % and 7 % annually over the last two years. Interestingly, the growth in industry has been stable at between 5 % and 7 % since 2000/01, and is projected to be above 6 % for 2005/06. A similar picture can be drawn for services with growth between 3 % and 6 % during the last three years and projected to land at 5 % this year. Again, it seems to be slow growth in the agricultural sector that is the main cause of the lower overall growth in 2005/06, which is expected to come out at 5 %.

[1] I have not found any formal division between the urban and rural sectors. The PASDEP states that "The contribution of urban areas to the Ethiopian economy can be approximated with the share of industry and services in GDP, as those are generally located in urban areas", and I have used this approach.

The *projected overall growth rate* for 2006/07 is in line with 2005/06 and will probably be around 5 %, which gives a per capita increase in GDP of a little less than 3 %.[2] This figure may become higher if foreign aid is increased in line with the intentions indicated before the political turmoil, provided that the situation is calmed and the polarisation in the Ethiopian society is reduced. Finally, if we look at the whole period from 1999/2000 to 2004/05 growth averaged about 5 % p.a. while average per capita growth was 2.1 % p.a.

2.2 The impact of rising inflation on macroeconomic prospects

Non-food inflation, measured by the annual increase in the consumer prices of non-food items (non-food CPI), shows that Ethiopia has had a rather sound price change pattern. This probably reflects the macroeconomic policies of the Government in recent years, and the level of inflation is well within a sound range. The non-food price increase has been between 1.6 % and 5.4 % p.a. during the last 6 years (see table 1 above). Moreover, the modelling framework that assesses different scenarios for the Millennium Development Goals aims to contain annual inflation below 7.5 percent despite a large increase in foreign aid (IMF 2006).

On the other hand, the highly variable food CPI reflects the volatilities in agriculture. For these items the price change has ranged from a 13 % drop to a 25 % increase, and this creates large problems for consumers and producers in adapting and planning for future economic dispositions. The reason for the lower food prices in 2000/01 and 2001/02 seems to be that the demand for agricultural products was lower (UN 2002), but also that agricultural production was higher in these years. Hence, rural incomes declined, which in turn forced many farmers to cut back on spending, and this reinforced the deflationary pressure. The drought that fully impacted on agriculture in 2002/03 and resulted in a failed harvest for very many farmers then put upward pressure on grain prices, causing the peak food CPI rise of 25 % in that year.

However, it is important to underline that coping with this problem of fluctuating prices necessitates both macroeconomic stabilisation policies and improved agricultural policies. With respect to the former, it is necessary that rural farmers are insured against bad harvests, and that they have the ability to draw on financial resources during drought periods in order to avoid selling off productive assets and to get production up and going as fast as possible. Moreover, making financial services available to farmers will also facilitate the development of the farms to persist droughts, such as the construction of irrigation systems. With respect to the latter, we will return to agricultural policies in more detail in section 3. Note, however, that such policies may prevent large drops in economic growth during droughts, and, needless to say, could prevent much human suffering.

Recently, at the end of 2005, consumer prices increased quite rapidly and have been estimated to be running at 11.7 % during the last 12 months. The peak is again influenced by the fact that food prices have been increasing more rapidly than other commodities, but the large increase in oil prices has also contributed considerably. However, inflation is expected to be reduced in line with the Government's actions, and is predicted to be 10.8 % for the year 2005/06 and to decline thereafter to 6-7 % (IMF 2006). Moreover, the IMF has indicated that the Government's proposals for securing macro stability are adequate.

In light of the expected increase in aid flows to Ethiopia it is important to keep an eye on inflation in the future. However, it is expected that much of the aid will finance investment in development infrastructure, which to a large extent relies on imports. Since this usage of aid will dampen the

[2] The World Bank CAS operates with a per capita growth that is slightly higher for the two last years – 3.8 % and 3.6 %, respectively. However, these figures are a few months older that the IMF figures referred to above.

inflationary pressure, inflation is not expected to become a problem. The IMF mentions that Ethiopia should be careful not to allow too rapid an expansion of domestic credit in this situation due to the inflationary risks, but at the present time this seems to be under the government's control (IMF 2006). Nevertheless, Ethiopia's huge ambitions on economic development pose large challenges in managing monetary policies and developing the appropriate instruments for liquidity forecasting and bank supervision (IMF 2006).

2.3 The impact of rising oil prices

Ethiopia does not use much petroleum fuel. Approximately 95 % of the energy consumed is derived from traditional energy resources, while the remaining 5 % consists of electricity and oil products. Nevertheless, about a third of the 40 % increase in imports into Ethiopia in 2004/05 stems from the rise in fuel costs, and the oil price has increased even more since then. Hence, the increase in the oil price has contributed significantly to the widening current account deficit. Moreover, although oil's share of total energy consumption is low, it is expected that its share will rise as the country becomes more developed. Note also that Ethiopia has been totally dependent on imports to meet its requirements for all types of petroleum products since the Assab refinery was closed in 1997.

The assessment of the impact of rising oil prices, whether as a result of *increasing international oil prices* or *removal of domestic subsidies*, should be separated into two categories. The first is the short-term effects, which are the direct impacts that can often be observed. In accordance with the ToR, I will confine this section to discussing the impacts on the Government's budget. Second, the possible long-term impacts of a high oil price are discussed in relation to the long-term development of Ethiopia.

Short-term impacts on the budget

One important immediate impact of a rise in oil prices is the increase in government expenditure on implementing the activities specified in its budgets and action plans. The implication of this is that either the government must reduce its ambitions in the areas affected by the increased oil price and cut back on the activities, or they must redirect resources from other parts of the budget. However, a reduction in subsidies on petroleum products works in the opposite way, giving more funds to prioritised government expenditure.

The government's expenditure on domestic fuel has soared since the increase in world oil prices mainly because it has kept fuel rates constant since December 2004. This subsidy has been growing with the rise in the oil price since the government is not in a position to reduce much of this consumption. Hence, the most likely impact is that the extra cost will have to be covered by other sectors and other government expenditures reduced accordingly.

One development goal that is particularly vulnerable to increases in oil prices is the development of roads and transport services since oil is a necessary ingredient in bitumen and fuel. It is important to construct roads and provide transport services in order to lower the transport costs of inputs and outputs for producers in more remote areas, and hence to increase their profits and wages for workers, and in order to make goods and public and private services more accessible for consumers. Moreover, a proper transport system facilitates mobility in the job market – people in remote areas can more easily take jobs in urban areas in times of hardship in the village.

The challenge for constructing roads when oil prices are increasing is first and foremost related to the cost of bitumen. In Ethiopia, the rise in the cost of oil has induced an increase in the price of bitumen that has doubled the per meter cost of constructing a road. Hence, for the same road construction budget Ethiopia can only afford to build half of the number of kilometres of tarred roads as before the oil price increase.[3]

Another important effect of rising oil prices is that the already strained balance of payments is worsened, and this affects the Government's ability to purchase imported goods necessary to implement the strategies in PASDEP. Ethiopia is reliant on a few crops for foreign exchange earnings and receives 80 % of its foreign currency from agricultural export commodities. The foreign exchange earnings are way below what is necessary to pay for the imports, and this problem is worsened by the fact that many of the export crops are highly vulnerable to adverse weather conditions. Historically, the gap between export earnings and import outlays has largely been covered by foreign aid, but the problem is now more acute due to the freeze in direct budget support. The problem of an increasing currency account deficit is also aggravated by the increased demand for imports due to fast economic growth and the government's ambitious infrastructural investment programme, which requires substantial imports.

The Government has taken measures to improve the balance of payments, and the main instruments have been stringent import controls, a large reduction in subsidies on retail gasoline prices and a postponement of public investments. One serious implication of the rise in oil prices and the other factors causing the lack of sufficient foreign exchange, is that the Government has delayed portions of its public investment plan in energy and telecom in order to maintain macroeconomic stability. Hence, developing electric infrastructure has been postponed. This could result in many poor people waiting even longer for connection since it will delay the ambitious rural electrification programme that intends to extend the grid to the rural areas where most of the poor are living. Only 17 % of the people are connected to the electricity grid (PASDEP 2006). However, it is not clear whether the investments in electricity are intended to connect poor people or whether they will favour the better off. If connecting new residents to the grid follows the existing pattern, then we would expect that the postponement would have little impact on the poor since the current distribution of electricity consumption is highly skewed towards higher income households.

The government has reduced subsidies on oil and gas products, which, according to the IMF, will help reduce inflation (IMF 2006). The explanation for this counter-intuitive prediction may be that the reduction in demand that follows the increased expenditure on petroleum products will counteract the direct effect from the increased prices of petroleum products. Note also that consumption of fuel is heavily skewed towards higher income levels, which are important in determining overall demand and hence prices. Moreover, government spending on petroleum subsidies could be used for pro-poor expenditures, such as basic services and infrastructure, and would in this case be more effective in reducing poverty. In addition, subsidies generally change relative prices in an inefficient manner. The Government can achieve more development for the same budget if it reduces bottlenecks for the different industries that need oil instead of subsidising oil. Taken together, it seems wise not to subsidise petroleum products and to focus government spending on targeted development efforts and on basic services important to the majority of the population.

The IMF has indicated that the government's proposals for maintaining macroeconomic stability are appropriate for meeting the balance of payments challenge. However, curbing spending that requires foreign exchange may slow down the pace of development in the longer term. This is addressed next.

[3] Assuming that the cost per kilometre is constant.

Long-term impacts

As noted above, rising oil prices increase the currency deficit. In the longer run, however, this may not be a problem in itself. It is expected that the political situation will stabilise, and the World Bank has already suggested that the government is on the right track towards restoring normal relations with the donor community. Hence, the donor community is expected to normalise aid disbursement in the longer term. The adjustments that the Government has embarked on are said by the IMF to be satisfactory to maintain macroeconomic balance. But even though the balance of payments may be positive in the long run, a high oil price makes it more difficult for Ethiopia to reach its development goals since oil is a crucial ingredient in much of these efforts.

One long-term impact of a rising oil price, or a constant high price level, is that pressure will be created for the privatisation of road construction so that government funds can be used for other purposes. This is not a rational response since the bill for having the road built has to be paid anyway, but this has already been raised as a proposal by the World Bank (World Bank 2006b). Another long-term impact is that fewer tarred roads will probably be built and more gravel roads, and this could lead to large maintenance costs and challenges that could hamper development. Similarly, it will be more difficult to improve other components of the transport system and fewer will be able to use motorised transport and traction. Transport costs have increased sharply due to the large rise in the oil price, and this limits the markets for inputs, goods and services that will constitute an even larger barrier against people interacting in market exchange. Moreover, the traditional system of using oxen for draught power for land development, tillage, threshing and transport (equines) will continue. Taken together, it will be even more difficult for the government to develop the subsistence economy that prevails in large parts of Ethiopia.

On the other hand, the increase in the oil price may also create new opportunities in Ethiopia. When the oil price increases, so does its natural substitutes, and energy prices have moved in tandem with the oil price. Hence, it becomes more attractive to exploit alternative energy resources. Ethiopia is endowed with hydroelectric power, coal, biomass, solar energy and natural gas, and possibly oil and geothermal energy. According to PASDEP 2006, only 2-4 % of Ethiopia's total potential for hydroelectric power generation has been developed, and this amounts to 15,000-30,000 MW. Another opportunity lies in natural gas exploitation. Reserves are estimated to be 24 million cubic metres and that may be sufficient for nitrogen-based fertilizer production.

Energy extraction in Ethiopia offers considerable potential, but also major challenges in human resources, know-how and technology. However, we see a growing interest from abroad in the energy sector in Ethiopia that may facilitate development of these resources. One example is the World Bank, which will embark on an assessment of the potential for a massive increase in the production of ethanol and biodiesel (World Bank 2006b). Another example is that the Ethiopian government has signed a contract with a big Chinese firm, China National Complete Plant Import & Export Corporation, to study the potential reserve for a coal mine in Yayu, Oromia state to produce urea fertilizer.

Finally, it is worth noting that most Ethiopian soils are deficit in nutrients, and that the application of nitrogen and phosphorus fertilizer has increased crop yields significantly. However, the production of nitrogen-based fertilizer is energy intensive (natural gas) and is one of the most price-sensitive commodities with respect to oil prices. Ethiopia imported 200,000 tons of urea fertilizer (46 % nitrogen) at a cost of 60 million US dollars in 2005. As the average price for 2006 is expected to increase by 20-25 %, Ethiopia is expecting to pay 12-15 million US dollars *more* this year for the same amount of fertilizer. To illustrate the magnitudes: the total cost for Ethiopia of the urea fertilizer in 2005 would require almost 8 % of *all* its export earnings generated in 2004/05. Moreover, the government's aim is to increase substantially the use of this type of fertilizer. Hence, one important input into modern agricultural activity has become much more costly after the increase in oil prices and poses a severe hindrance to one of the main strategies for developing Ethiopia – rural development and improved agricultural productivity.

2.4 Prospects for exports from Ethiopia

In section 2.1 we underlined the importance of agriculture for achieving stable growth in Ethiopia, and note that 90 % of the poor make their living in agriculture. In this section we go into somewhat more detail on the prospects for agricultural growth in the short and medium run through exports, and we assess the prospects of other activities that may bring more foreign exchange into the country. In the long run it is clear that the importance of agriculture for the economy and poverty reduction will be reduced. However, it takes time to complete a transition in which uneducated subsistence farmers move to paid skilled labour.

The major export products from Ethiopia in 2004/05 were coffee (41 %), oilseeds (13 %), Khat[4] (12 %), leather and leather products (8 %), gold (6 %) and pulses (4 %). The prospects for *coffee* production are not very promising in the long run, for at least four reasons. First, as the incomes of the countries that import coffee grow, the demand for coffee grows less. Hence, it is not expected that there will be any large increase in coffee demand, and increasing production would bring the price down. Second, the price of coffee would increase little even if the demand should increase, and hence the revenue for farmers will not increase very much even in the best growth scenarios. Third, the price of coffee has gone down relative to the price of the goods that Ethiopia imports. Coffee provided 65% of Ethiopia's export earnings a decade ago, but this is now down to 41 % due to the lower prices – even if the coffee price in 2004/05 was at its highest in the last 5 years. Hence, Ethiopia today can buy substantially less oil, machinery, fertilizer and equipment from abroad for the same amount of coffee production compared to a decade ago. Fourth, international commodity agreements have not fared well. Coffee-producing countries have tried to organise themselves in cartels similar to what OPEC did for oil, in order to stabilise prices at a higher level. However, the initiatives have largely been ignored by the coffee producers because it is more costly for them to reduce production as compared to oil production, and it seems that there is a long way to go before such an arrangement can be established.

In the medium and short run, however, it is important to note that coffee exports are a necessity for bringing in foreign exchange. Several actions can be taken to improve the earnings from coffee in such a perspective. First, note that the coffee price is very volatile, as is illustrated by the 62 % increase in the coffee export price for Ethiopian farmers that they experienced between 2002/03 and 2004/05. Hence, the producers need to be able to build up income buffers in good times to draw on when the coffee price is low, or when the crop fails. Given the poor functioning of financial markets in Ethiopia, and the fact that most farmers avoid taking risks, this problem may be a substantial hindrance for increasing coffee production in the short run. Moreover, there are several hindrances for expansion in coffee; most of them are addressed in the PASDEP and will not be discussed here.

The scenario for *all other major export products* of Ethiopia suffers from the same conclusions as drawn for coffee, except for the fact that the price of pulses has remained remarkably stable over the last 6 years. However, it is very difficult to assess future opportunities in agriculture. Who predicted the enormous rise in horticulture in many African countries, especially fresh cut flowers, which have now also taken off in Ethiopia? It is clear that the demand for these products rises rapidly with increased incomes, and it is expected to be a lucrative business in the future. Moreover, given the high transport costs from Ethiopia to the world market, it may be worthwhile assessing whether

[4] The traditional khat is a leafy shrub that has psychotropic qualities when chewed.

such low weight/high price commodities as fresh cut flowers and spices can be produced on a large scale in Ethiopia.

Tourism has grown to be one of the most important foreign exchange earning sectors worldwide and is now the fourth largest export article even if we exclude air travel costs. In particular, tourism to Africa has the highest growth rate – 10 % more tourists travelled to Africa last year and 11 % more in the first four months of 2006. Uganda is one example where tourism has become the most important foreign currency earning sector, and is now bigger that the second and third most important sector combined. With its cultural heritage and magnificent scenery, Ethiopia has an enormous potential for developing its tourist industry and taking part in the huge growth in this sector. Needless to say, as the world becomes richer and richer, working time is reduced and people use more time and resources on their vacation. Hence, the increase in tourism will continue in the long run, and more and more people demand exotic travel destinations. This may be an opportunity for Ethiopia, and the PASDEP notes that the long-term vision of the Government is to make Ethiopia one of the top 10 tourist destinations in Africa. Moreover, a long list of concrete actions to attract more tourists is presented. However, there is strong competition among tourist destinations, and hard work must be undertaken by the government to provide the tourist facilities and intensive advertising is necessary in order to promote Ethiopia. In any case, any effort to attract more tourists would probably be wasted as long as domestic political tensions, famines, and potential armed conflicts with Eritrea and Somalia continue to be headlines in the international press.

The *mining sector* has been underexploited in Ethiopia, even if gold is one of the major export commodities. Despite the often unfavourable relative price changes of raw materials, several of the products can generate huge income, diversify exports and bring badly needed foreign currency. Moreover, such development contributes to industrial development and employment opportunities in the small-scale mining sector that give the workers far higher incomes than traditional agriculture. Only 38 % of the country has been geological mapped, and the PASDEP lists a number of actions to increase coverage since many different mineral deposits have been identified. PASDEP notes that studies indicate that 400-500,000 people are engaged in artisan (gold and salt) mining in different parts of the country; and among these half are female. Even so, one should note that the major potential for the economy lies in the income that is generated in the mining business since it tends to employ relatively few people.

2.5 Does the Protection of Basic Services programme compensate for the suspension of Direct Budget Support?

The donor community has taken several actions in response to the political turmoil caused by the electoral irregularities during the May 2005 elections in Ethiopia and the mass arrests and human rights violations that followed. One important step was to halt Direct Budget Support (DBS) and use alternative forms of aid disbursement that "would provide greater oversight over poverty reducing expenditure and promote increased accountability". Thus, it would be interesting to assess to what extent the alternative aid programme, the Protection of Basic Services (PBS)[5] programme, compensated for the absence of DBS. However, it turned out to be a very difficult task to find information on the relative share of aid that should have gone as DBS to Ethiopia from the

[5] Basic services are defined by the World Bank as follows: "basic services is defined broadly to include services delivered at the sub-national level that directly contribute to poverty reduction or have a social impact (primary and secondary education, health, water supply & sanitation, rural roads, agricultural extension, labor, social welfare); services that contribute to poverty reduction via their impact on economic growth; and spending on core administrative services, without which budgets could not be prepared or approved, payments made, accounts maintained, etc, and which will be critical if the state's accountability to its citizens is to be improved."

suspension in late 2005/beginning of 2006 and two years ahead. The indications given in this section are therefore tentative and require further work in order to draw any firm conclusions.

According to the World Bank Project Information Document of the PBS, this programme consists of four components that will run from 2005/06 to 2006/07: (1) funds for basic services, (2) provision of health commodities, (3) financial transparency and accountability, and (4) social accountability. In sum, the total cost of the programme, excluding the Government's own spending, was planned to be approximately US$ 468 million over the two years. The aim of the PBS is to provide the required funding so that the Government does not have to cut pro-poor spending over the next two years, especially at the sub-national levels (regions, cities and local authorities). However, according to a press statement from the World Bank the PBS did not start up until late in 2006 and was to last for only 14 months.

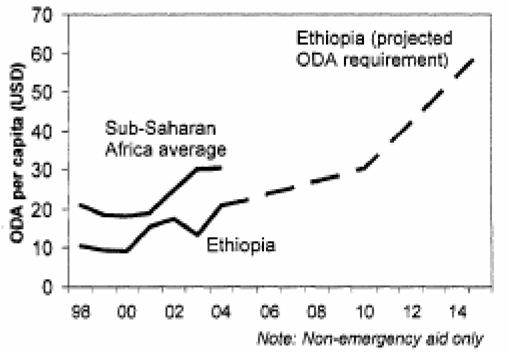
First, if we compare the annual PBS amount for 2006/07, i.e. US$ 401 million, with the current account deficit in 2004/05 *excluding official transfers like foreign aid*, which was US$ 1,763 million, then we see that the PBS is of considerable importance in reducing the current account problem. To illustrate the point further, PBS brings in as much foreign currency in 2006/07 as 50 % of total exports from Ethiopia did during 2004/05. Second, if we compare the PBS with the total amount of foreign aid given to Ethiopia in 2004, which was US$ 1,800 million, we see that the PBS accounts for almost 23 % of total Official Development Assistance (ODA) to Ethiopia. We also know that a relatively large share of the ODA to Ethiopia is given to projects and NGOs and hence did not go through Direct Budget Support. Thus, it seems that the PBS to some extent mitigates the negative effects of the suspension of DBS on the macroeconomy, but we need the figures to conclude on this issue.

This preliminary discussion indicates that the magnitude of the PBS plays an important role in reducing the foreign currency problem of Ethiopia and maintaining macro balance, and that the programme has such a magnitude that it will also help in fostering economic growth.

Finally, the donor community also threatened to reduce aid over time if the political turmoil was not handled adequately and governance did not improve. Reducing aid would have tremendous implications for the Ethiopian economy in the coming years and jeopardise the recent good economic performance.[6] First and foremost, the vital import requirements (petroleum products, technical equipment and construction materials) would not be available for entrepreneurs and development projects, and economic growth would be reduced. Moreover, such a move would imply that the Millennium Development Goals would not be met. Figure 2 illustrates the importance that increased aid has in meeting these goals.

[6] It is necessary to underline that reducing aid to Ethiopia in a situation where more aid is promised may also strain the relations between the donor community and the Government. However, the political implications of aid giving are beyond the scope of this report.

Figure 2. Ethiopia's ODA requirement to meet the Millennium Development Goals



Source: World Bank (2006b)

As can be seen, it is estimated that achieving the MDGs requires huge increases in aid flows. Moreover, several other challenges need to be addressed before Ethiopia can come onto a path towards achieving all the MDGs. The MDG of reducing poverty is discussed next.

3. Strategies and prospects for poverty reduction

In this section, I will discuss (in line with the ToR) the challenges for the Ethiopian poverty reduction strategy as specified in the PASDEP, and the aims therein. In section 3.1, I assess the poverty analysis in the PASDEP and whether this is coherent with the strategies. Then in section 3.2, I review how pro-poor the growth strategy is, and look at the prospects for poverty reduction. Finally, section 3.3 contains a discussion on how the PASDEP balances growth with the distributional aspect.

3.1 Poverty analysis and the strategies for poverty reduction

Ethiopia's new five-year poverty reduction strategy, the Plan for Accelerated and Sustained Development to End Poverty (PASDEP), was endorsed by the House of Peoples' Representatives in May 2006. The main aim is to increase economic growth and, as a minimum, to achieve the Millennium Development Goals. The plan contains eight strategies: (1) A massive push to accelerate growth - commercialisation of agriculture and promoting much more rapid non-farm private sector growth; (2) geographical differentiation – including urban issues; (3) reducing population growth; (4) reducing gender discrimination; (5) constructing infrastructure; (6) risk management and reducing vulnerability; (7) scaling up service delivery to reach the MDGs; and (8) increasing employment.

The PASDEP addresses the volatility of growth (in particular agriculture), population control, health and water issues, policies and institutions, investment requirements, building human capital through education and skill enhancement, the need to acquire new technologies in partnerships with international companies, and the development of infrastructure (roads, electricity, telecoms). Moreover, the PASDEP also rises the important issue of unleashing the growth potential of Ethiopian women and enabling them to participate in the economy on an equal footing with men. All of these issues are vital for high economic growth in a country like Ethiopia, and lay a sound foundation for the strategies for implementation of the policies to achieve the goals.

The relationship between the poverty analysis and the strategy for poverty reduction is clear, even though the poverty analysis as spelled out in the document seems a bit shallow. Moreover, since the strategy requires a 7 % annual growth in agriculture, which is very ambitious, more attention should have been paid to how this growth will be achieved in the long run. Despite rather detailed description of inputs, no analysis is given on how the different components will translate into income generation and how large the overall agricultural growth will be. PASDEP also lacks an analysis of what the major obstacles to agricultural growth have been and there are no attempts to explain why agriculture only contributed 0.3 % to growth over 1993 – 2003. Such an analysis would then be the foundation for a strategy specifying how these obstacles would be tackled under the PASDEP period.

The challenge in agriculture is aggravated by the fact that many of the subsistence farmers are under the national food security programme, which aims to improve the food security of 16 million people within 5 years, and make 6 million of these food self-sufficient within 3 years. Hence, the focus will be to enable these people to cope with the harsh environment, and that may entail giving up on achieving the 7 % growth for these people since high-yield technology often implies higher risk. Moreover, a discussion of regional differences in agricultural potential should have received in-depth analysis due to its crucial role in achieving the growth goal. However, we should expect that the Government is already developing a more detailed plan for how to achieve the agricultural goals in the PASDEP, as this is mentioned for several of the agricultural strategies.

In general, it is my opinion that Chapter 1 in the PASDEP, which analyses the present situation and spells out the strategies, seems rather short in comparison to its importance. However, there is always the issue of limiting the length of the PRSPs as to make them more accessible to a wider audience, but perhaps other sections should be cut back. Much of the underlying work seems to be thorough and of high quality, although I have not had an opportunity within the timeframe of this project to study them in detail. There is, however, a clear understanding of the magnitude of the poverty challenge, and assessments have been undertaken both to analyse what could be learned from the previous PRSP, what one can learn from others (long-term analysis on sources of growth carried out by MoFED that, among other issues, draw lines to Asian countries' growth experiences), and what the financial and political requirements for achieving the goals would be in different scenarios. Moreover, the PASDEP uses the Millennium Development Goals Needs Assessment in its analysis and planning. Taking into account the thorough description and analysis in SDPRP, in which international specialists from the University of Oxford participated, I am not surprised to see the high quality of the PASDEP.

3.2 Degree of pro-poor growth strategy and the prospects for poverty reduction

In this section I discuss whether the PASDEP will make sure that Ethiopia keeps on track towards achieving the Millennium Development Goals and look at the degree to which the growth strategy is pro-poor. Looking at the figures for 2000, there were 31 million people in Ethiopia that lived below the national poverty line of US$ 0.45 a day. MoFED studies show that a 1 % increase in growth reduces poverty by 1.3 %, and it has been shown that a growth rate of about 8% p.a. is necessary in order to achieve the MDG of halving income poverty by 2015 (PASDEP 2006). This is higher than the annual average growth rate in Ethiopia of 5 - 6 % during the 13-year period from 1993 to 2005/06. On the other hand, much of the expenditures and investments in the PASDEP are focused *more* on poverty reduction (see section 3.3 for details) than earlier, so we would expect that a 1 % increase in growth would reduce poverty more than the 1.3 %. Nevertheless, without much faster growth than in the previous decade, Ethiopia will not have the revenue to finance essential health, education, infrastructure, and other services important to poverty reduction.

If we look at Ethiopia's growth experience in shorter periods, there may be reason for some optimism. In the years prior to the drought, i.e. 1998/99 to 2000/01, Ethiopia experienced an average annual economic growth of 6.6 % (see table 1 above) despite the border war with Eritrea from 1998 to 2000 that killed 70,000 people and put some of their agriculture out of production. If we discard the rebound that occurred after the drought, which resulted in 11.3% growth in GDP, and concentrate on the two consecutive years, we see that the annual average growth was 7 %. Hence, history shows that a high growth rate is possible in this country, and that coping with droughts is of major importance in order to avoid setbacks. Moreover, it is important for Ethiopia's ability to prosper that the tense situations with Eritrea and Somalia do not escalate into armed conflict or war. The administrative capacity, the manpower and the peoples' focus must be directed towards poverty reduction if they are to have any chance of achieving the goals.

Another challenge to poverty reduction is the high population growth rate, ranging between 2.2 % (WB estimate) and 2.8 % (PASDEP estimate). Clearly, it poses a serious challenge to have 1.5 – 2.0 million new mouths to feed every year and to create jobs for the growing population where the agricultural plots are already too small to support their consumption. This challenge is adequately addressed in the PASDEP with a range of different actions proposed. The main poverty-reducing vehicle in the PASDEP is investment in and expenditure on *agriculture*. The aim of making 6 million people food secure and improving food security for another 10 million is a substantial contribution towards poverty reduction since most of these people will at some point in time be counted as poor. Moreover, development aims in agriculture are largely directed towards poverty reduction. Poverty reduction is also addressed in most of the other sectoral strategies in the PASDEP, and some examples are given here.

In the *Road Investment strategy*, poverty reduction is incorporated through a special programme designed to built rural roads to reach the poor in remote areas. As they state: "The Ethiopian landscape is characterised by widespread poverty, rugged terrain, skewed distribution of population and inadequate road network and transport services. This has resulted in weak spatial integration, predominance of rural settlements in isolation from one another and low economic activity. All these together have constrained the growth process and compounded the poverty problem, making it a vicious circle."

The Government launched a study on Poverty Impact of Transport Operations in selected corridors in 2004, and now the '*Transport and Poverty Observatory: A Yearly Customary Assessment*' is conducted annually to monitor the poverty-reducing impacts of road investment at local community and at household level. The PASDEP specifies that 10,500 km of low-class rural roads are to be built in the period, while 7500 km of regional roads and 3900 km of federal roads are to be built. Moreover, clear targets of reducing walking distances for the rural population to the nearest road are presented. While indicating that the poverty aspect of road investment is taken seriously, it is not possible to assess the degree of pro-poor spending in this sector without going into the detailed background documentation.

The PASDEP strategy of developing the *tourism industry* also incorporates ideas on how to use this as an instrument for reducing poverty by promoting links to marginalised constituencies – especially women, rural areas, and poor communities. Moreover, it is an aim to link attractions and local communities to increase the sharing of the benefits of tourism and to link communities with handicraft services supply and support services. Moreover, a series of Sustainable Tourism Eliminating Poverty pilot projects will be identified and conducted with the technical collaboration of the World Tourism Organisation. The intention is to improve the distribution of tourism income to poor people in the community. Again, it is difficult to assess the degree of poverty reduction in relation to the spending and investments in the strategy.

Very few poor Ethiopians are connected to the *electricity* grid, and this aggravates poverty due to deforestation, difficulties for children to do homework in the evening and so on. One important component of the PASDEP is the large-scale rural electrification programme, called the Universal Electrification Access Program. Recalling that 90 % of the poor live in rural areas, this may be important for poverty reduction. The aim is to increase access to 24 million people, which implies 50 % coverage within five years.

Finally, the ToR for this report asks for an assessment of whether increasing the per capita incomes of the poorest from US$ 1 to US$ 2 per day within five years is realistic.[7] The PASDEP scenarios all have a 7 % growth rate for agriculture, which is the sector that 90 % of the poor are dependent on for their living. We also know that the actual average growth figures conceal important differences between households – some may have a much higher growth while others will lag behind. However, if for the purpose of illustrating the challenge we assume that all the poor earn US$ 1 and that they all experience a growth rate of 7 % a year, then they will have US$ 1.5 after 5 years. An annual *per capita* growth rate of 15 % is necessary for *all* of the poor in order to double their income over 5 years. Given that the most optimistic scenario in the PASDEP suggests a growth rate of 7-8 % *per capita*, this goal of doubling the incomes of the poorest is clearly not realistic. However, the goal of achieving the MDGs is clearly within reach under the current macroeconomic regime if the PASDEP is implemented, if Ethiopia does not suffer from extensive drought and if the political situation stabilises. The large requirement of funding the PASDEP is clearly a challenge that the donor community must discuss.

3.3 How does PASDEP balance growth and inequality issues?

The PASDEP seems to balance economic growth and inequality issues in a sound manner given the widespread poverty in Ethiopia. When the majority of the population can be characterised as poor, then general policies aimed at the sectors where a majority of the poor is working will be effective in reducing poverty *and* reducing inequalities. The best example in the PASDEP is from agriculture where 90 % of the poor earn their living. Even though many of the policies apply to all types of farmers, the sum of the impact will be that inequality will go down because the poorest will benefit more than the non-poor farmers. One concrete example is the application of modern inputs. Many of the better-off farmers already use such inputs, and hence, this policy will probably reduce the gaps in income between the poor and the non-poor farmers.

The total Government expenditure, both recurrent and capital, consists of a relatively high share of poverty targeted expenditure for 2004/05, approximately 57% of overall spending excluding special programmes. Again, this reflects the challenge of widespread poverty in Ethiopia. However, when 40 % of the population is defined as poor and 57 % of government spending is targeted on them, it seems to be a rather strong effort for equalising incomes since there are many government outlays that benefit the poor even if they are not directly targeted towards them (governance expenditure). The PASDEP specifies that the share that goes to poverty reduction will be 80 % in 2009/10, which seems very high. However, a more thorough assessment of this point and the definitions of "pro-poor spending" is necessary if we are to conclude more firmly on the degree of inequality reduction in the Government spending.

Moreover, it is evident that the PASDEP is only concerned about the inequality between the poor and the non-poor to the extent that the aim is to lift the poor over the poverty line. Hence, this will contribute to smaller inequalities if the economic growth of those above the line is not larger than the growth of those below. I do not find *any* discussion of income-inequality reducing policies in

[7] However, I did not find any such goal in the draft PASDEP of December 2005.

the plan. However appropriate at this stage where the main aim is to reduce poverty, it is important to highlight that measures taken in the PASDEP period could alter future income distribution in an irretrievable manner. Therefore, it is a problem that no attention is paid to income distribution issues.

The rough categorisation of income classes, i.e. in poor and non-poor, may be appropriate in Ethiopia's situation since most of the population is below the poverty line of US$ 1 a day, and since most of those above that line are not very rich. Many of the targets and actions are directed towards all households in areas where the programme is being implemented, or the selection of the recipients of the programme is not specified in case there are not enough resources for universal coverage. Take delivery of health services, for example. In the lowest resource scenario there will be a roll-out of the Health Service Extension Programme, with the establishment of two HEWs and a low-level health post for each kabele over the next five years. Hence, there is no taking into account the differences in health needs between the kabeles, for example between poorer and less poor areas.

A similar approach is used in the education sector. However, it seems that some of the financing of the ESDP III will be borne by the students themselves: "The cost that will be shared by pre-tertiary (Grades 11 & 12), TVET and tertiary level students will also be another source to finance ESDP-III.", p. 87. School fees in a country like Ethiopia will hamper economic growth and prevent many talented youngsters from attending school because they are too poor to afford it.

PASDEP does take into account that growth tends to be unevenly distributed. However, no attempt is made to formulate policies that would change the distribution from the better-off towards the poorer. It is evident that if growth were accompanied by less inequality, then the economic growth would lead more people out of poverty compared to a situation where growth leads to higher inequality. MoFED studies show that a 1 % increase in growth reduces poverty by 1.3 %, but the same growth *increases* inequality by 1.1 %. Hence, we expect increasing inequalities during the PASDEP period. This should be analysed, and counter-measures should be proposed.

4. Suggested issues to follow up

4.1. The PASDEP commits the Government to developing several sub-sectoral agricultural plans that will be vital for the goal of achieving the 7 % annual agricultural growth target at the same time as securing food self-sufficiency for vulnerable subsistence farmers. Hence, we should expect that the Government is already developing more detailed plans, and one issue for the Norwegian Embassy could be to follow up this work with the Government and discuss the different scenarios that rise from such planning. The financial need is evident, and the donor community will probably at some point discuss how to contribute to the financing gap. In that case it would probably be valuable for the embassy to monitor the work on these plans closely.

4.2 Norway has a vast experience in energy management and development, and has recently included oil expertise in foreign assistance. There seems to be potential for further engagement from Norway in fostering institutions in Ethiopia necessary for exploring and developing the energy sector in the country, and perhaps particularly focus on natural gas exploration and usage of gas to produce nitrogen-based fertilizer.

4.3 In the present situation, it is my opinion that it is very difficult to predict Ethiopia's inflation three years ahead. Inherently difficult, this task is made much harder by the fact that we do not know when and how the expected increase in aid will occur, and how this will affect the other economic dispositions of the government. In light of the expected increase in aid flows to Ethiopia it is important to keep an eye on inflation in the future. Credit growth is needed to fuel the growing economy and to secure financing for the projects that actually drive the economic growth. Ethiopia's huge ambitions for economic development pose large challenges in managing monetary policies and developing the appropriate instruments for liquidity forecasting and bank supervision.

4.4 The long-term vision of the Government to make Ethiopia one of the top 10 tourist destinations in Africa may be followed up. Norway has a long experience in attracting high-value tourists that seek exotic adventures. This may also be an opportunity to express concern over the continuous insecurity due to the conflicts with Eritrea and Somalia and to underline that the Government's efforts to attract tourists are undermined by the constant threats of violence.

4.5 It is a concern for inequality that some of the financing of the education strategy will be contributed by the students themselves: "The cost that will be shared by pre-tertiary (Grades 11 & 12), TVET and tertiary level students will also be another source to finance ESDP-III." (PASDEP, p. 87). School fees in a country like Ethiopia will hamper economic growth and prevent many talented youngsters from attending school because they are too poor to afford it. This should be of major concern, and an issue that should be raised with the Government.

4.6. The PASDEP is only concerned about the inequality between the poor and the non-poor to the extent that the aim is to lift the poor over the poverty line, and there are not any discussions of inequality-reducing policies in the plan. Hampering growth and creating a more unequal society, it is unfortunate that no attention is paid to distributional issues. This may be appropriate in Ethiopia's situation since most of the population is below US$ 1 a day, but to set the focus on this issue the embassy could ask the Welfare Monitoring Unit (which was established with Norwegian aid grants) in MoFED to undertake such a study, and CMI could be a sparring partner in this work.

4.7 The preliminary discussion of the impact of the suspension of General Budget Support indicates that the magnitude of the PBS plays an important role in reducing the foreign currency problem of Ethiopia and maintaining macro balance, and that the programme has such a magnitude that it will also help fostering economic growth. However, the indications given in this report are tentative and require further work in order to draw any firm conclusions. This could be undertaken in a follow-up study if the figures are made available.

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Terms of reference

GLO-2028. Etiopia – konkretisering av oppdrag

Bakgrunn

Det vises til brev fra Norad til CMI av 16. januar 2006, med bestilling av faglige tjenester fra CMI v/dr. Espen Villanger til ambassaden i Addis Abeba, med en ramme på i størrelsesorden 2 månedsverk i 2006.

Innenfor denne bestillingen, konkretiseres følgende oppdrag:

Desk-studie om den makroøkonomiske situasjonen i landet og utsiktene med hensyn til fattigdomsreduksjon.

Innhold

<u>Når det gjelder den økonomiske situasjonen i 2006 og forventet utvikling fremover, vil følgende spørsmål være sentrale:</u>

- Forventet vekst i BNP for 2006 er på 7%. Er dette realistisk og hva innebærer det mht vekst pr. capita? Hvordan fordeler veksten seg på sektorer og på rurale vs. urbane strøk?
- Hvilke konsekvenser antas den økende inflasjonen å få for den makroøkonomiske utviklingen?
- Hvordan har økende petroleumspriser påvirket budsjettet for 2005/2006? Er det mulig å si noe om kortsiktige og langsiktige trender basert på en stabilt høy/evt. stadig økende oljepris?
- Myndighetene har redusert subsidiene på import av olje og gassprodukter - hva antas å være de langsiktige konskvensene av dette?
- Hva har stansen i utbetaling av Direct Budget Support (DBS) å si for den nasjonale økonomien? Hvor mye av tapet vil eventuelt Protection of Basic Services (PBS) programmet, øremerket sektorstøtte utbetalt direkte til regionene, demme opp for?

<u>Når det gjelder planer og utsikter med hensyn til fattigdomsreduksjon, bes følgende spørsmål belyst:</u>

- Etiopia har nettopp vedtatt en ny fattigdomsstrategi (PASDEP) som har som målsetting å doble inntekten til den fattigste delen av befolkningen fra 1 USD til 2 USD i løpet av fem år. Synes dette realistisk, gitt landets befolkningsvekst, den makroøkonomiske utviklingen i landet, den politiske situasjonen og tiltak nedfelt i strategien?
- Hvilket samsvar er det mellom fattidomsanalyse og strategi for fattigdomsreduksjon? Hvor fattigdomsrettet er veksten, og i hvilken grad tar strategien sikte på å gjøre den mer fattigdomsrettet? Hva er forholdet mellom vektlegging av vekst generelt og fokus på fordeling?
- Etiopias fattigdomsstrategi er relativt ensidig rettet inn mot vekst i landbruksproduksjon (herunder stor grad av subsistence farming). Hvor mye av de siste års økonomiske vekst kan tilskrives landbrukssektoren, i forhold til andre sektorer som industri- og servicesektor i urbane strøk? Hvordan slår økonomisk vekst i urbane strøk ut på fordelingsmekansimer/vekst i rurale strøk? Er det mulig å si noe om kortsiktige og langsiktige trender i prisutvikling for sentrale eksportprodukter fra Etiopia, spesielt kaffe?

- Hvor realistisk er gjennomføringen av PASDEP, gitt manglende bistandsstøtte til sentraladministrasjonen og etiopiske myndigheters implementeringskapasitet?

De to hovedtemaene og underpunktene er delvis overlappende. Det viktigste vil være å få et godt bilde av de sentrale utviklingstrekkene og politiske prioriteringene når det gjelder økonomi og fattigdomsreduksjon. Grunnlagsdokumenter vil bl.a. være IMFs rapport "The Federal Democratic Republic of Ethiopia: Selected Issues and Statistical Appendix" av 05.05.06 og Etiopias nye fattigdomsstrategi (PASDEP).

Gjennomføring

Oppdraget gjennomføres innen en ramme på 10 arbeidsdager. Utkast til rapport oversendes elektronisk til ambassaden og til Norad senest fredag 21. juli 2006, for kommentarer. Det legges inn rom for noe kommunikasjon og oppfølging etter at utkastet er oversendt, samt innarbeidelse av ev. justeringer i endelig versjon.

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SUMMARY

The report analyses Ethiopia's economic performance and expected future development. The economic growth rate is likely to remain high despite large fluctuations in agricultural production. Projections indicate, however, that Government's target of 7 % growth for 2006 is around 2 percentage points too high. Higher growth rates are expected if political polarization in Ethiopia is reduced. The rising inflation has been a source of concern, but price increases now seem to be under control. The increase in oil prices and the suspension of Direct Budget Support by donors are other factors straining the Ethiopian economy. In this situation with scarce foreign exchange, the removal of petrol subsidies seems warranted.

Furthermore, challenges for the Ethiopian poverty reduction strategy (PASDEP) are discussed. The PASDEP clearly links growth strategies to poverty reduction, and the poverty analysis in the document is coherent with the strategies outlined. However, distributional issues seem to be overlooked and further analysis is needed to identify which groups will benefit from the proposed policies and which groups will lag behind.

The report, commissioned by the Norwegian Embassy in Addis Ababa, points at the following main issues for the Embassy to follow up:
•Assess Norway's potential for fostering institutions for exploring and developing the energy sector in Ethiopia
•Monitor the efforts by donors to close the financing gap in the PASDEP
•Address the importance of maintaining peace and stability for economic performance in general, and for the tourist industry in particular
•Address the inefficiencies of user fees in primary education
•Commission a study of distributional effects of implementing the PASDEP
•Commission a study of the impact of the suspension of Direct Budget Support

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